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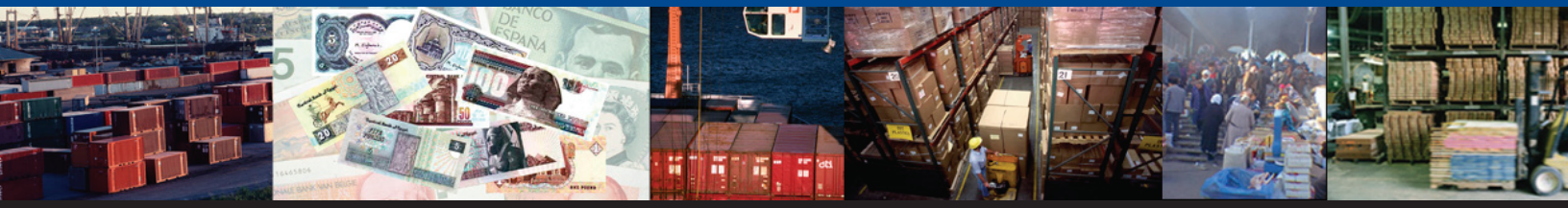
SOUTHEAST ASIA COMMERCIAL LAW AND TRADE DIAGNOSTICS – INDONESIA

FINAL REPORT



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UNITED STATES AGENCY FOR INTERNATIONAL DEVELOPMENT

SOUTHEAST ASIA COMMERCIAL LAW & INSTITUTIONAL REFORM AND TRADE DIAGNOSTICS – INDONESIA

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delivering results that endure

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INTRODUCTION

Indonesia: Recovery from the Past and Challenges for the Future

The 1997 economic crisis in Southeast Asia affected the entire region, but devastated Indonesia in particular. In less than a year, the value of the country's currency fell by roughly 90 percent and gross domestic product (GDP) plummeted by nearly 14 percent, prompting rampant inflation, vast unemployment, and widespread violence. The crisis culminated in political upheaval. In the spring of 1998, a new president replaced the 32-year dictatorship of General Suharto. In the aftermath, as the corruption and poor governance of the recent past became more fully exposed, a new commitment to democracy and strengthened institutions emerged.

Ten years later, an array of legal and institutional reforms has revealed Indonesia's promise. Among other developments, Indonesia has begun to address its reputation for "crony capitalism" through more rigorous corporate governance and improved transparency in banking transactions. The state's entrenchment in the economy has diminished; the number of state-owned banks has decreased from 13 to four, for example. The government has also increased the number of opportunities afforded smaller entrepreneurs and plans to adopt additional regulatory measures that will support this important group. In the area of competition law and policy, Indonesia has exhibited important leadership in the region. Top officials in the economic ministries exhibit genuine commitment to international rules of trade and investment, and the process of moving goods across borders has improved significantly. There is also a major political commitment to combating the country's notorious reputation for official corruption.

> Indonesia must embrace a higher level of expectations for economic performance than it has entertained in the past—it must aspire to more rigorous standards of transparency, productivity, and opportunity.

However, poverty in Indonesia remains widespread—nearly half the population lives on less than $2 a day—and the list of challenges that threaten the country's potential for sustained economic growth is long. Indonesia's fundamental challenge is to entertain higher expectations for economic performance and meet more rigorous standards of transparency, productivity, and opportunity. Indonesia requires better information management and administrative competence in all branches and at all levels of government, along with a strengthened commitment throughout the public and private sectors to professional development and institutional transparency. It also requires an invigorated commitment to fair and streamlined conditions for entrepreneurship, including an aggressive approach toward dismantling an overly formalistic and insufficiently competitive regulatory structure.

The SEA CLIR Trade Diagnostic: A Regional Initiative

This report constitutes the fifth and final installment of a USAID-sponsored initiative to understand and respond to economic growth, harmonization, and integration efforts in five emerging economies of Southeast Asia—Vietnam, Laos, Cambodia, the Philippines, and Indonesia. The Southeast Asia Commercial Law and Institutional Reform and Trade Diagnostic Activity (SEA CLIR Trade) is designed to allow USAID's Regional Development Mission/Asia, the governments of these countries, and other interested entities to better understand the opportunities for commercial law and trade reform in Southeast Asia. It also establishes a baseline upon which USAID can prioritize future regional technical assistance.

First, SEA CLIR Trade examines the status of commercial law and trade facilitation in each of the participating states, including each country's respective strengths, weaknesses, and opportunities for reform. Through the comprehensive methodology established during USAID's Seldon Project for Global Trade Law Assessment and Assistance,[1] this diagnostic examines:

- Company Law and Corporate Governance
- Contracts Law and Enforcement
- Real Property
- Secured Transactions
- Bankruptcy
- Commercial Dispute Resolution
- Court Administration
- Competition Law
- Foreign Direct Investment
- International Trade Law
- Flow of Goods and Services
- Flow of People[2]
- Flow of Money
- Financial Crimes
- Intellectual Property.

Then, based on individual country reviews and opportunities for broad-based response to individual country findings, SEA CLIR Trade yields an overall regional diagnostic that:

- Makes intra-regional and subject-matter comparisons of international trade and commercial legal frameworks and associated institutions
- Identifies regional commercial law reform and trade-capacity needs and establishes program- and project-level priorities
- Benchmarks and evaluates regional progress toward an international trade- and business-friendly legal and regulatory environment
- Provides analytical and planning tools and metrics that will help design new regional strategies and approaches for sustainable, cost-effective reform activities.

The Diagnostic Methodology: A 360-Degree Review

The examination of commercial and trade-related law and institutions in Southeast Asia, from both individual country and regional perspectives, involves a comprehensive and flexible framework for analyzing complex and dynamic development challenges. Taking data from a broad spectrum of stakeholders, the diagnostic builds a "360-degree picture" of the challenge.

Legal Framework. These indicators review the laws and regulations that serve as the structural basis for Indonesia's ability to achieve and sustain market-based development. They pose a number of questions. Preliminarily, how clear are the laws, and how closely do existing laws reflect emerging global standards? How well do the laws respond to commercial realities that

[1] Detailed information about the Seldon Project is available at www.bizlawreform.com.

[2] For the purposes of this diagnostic, "flow of people" refers to the legal movement of individuals across international borders for trade-related reasons, such as tourism or the provision or consumption of legal services.

end-users face? What inconsistencies or gaps are present in the legal framework? This review often uncovers opportunities to make relatively small changes that result in significant openings for business development and expansion.

The 360-degree picture:

- Legal Framework
- Implementing Institutions
- Supporting Institutions
- Social Dynamics

Implementing Institutions. Next, the indicators examine institutions that hold primary responsibility for implementing and enforcing the legal framework and subsidiary laws, regulations, and policies. These institutions typically include government ministries, authorities, and registries, and, in certain cases, private institutions such as banks and credit bureaus. Courts are often examined with respect to their effectiveness in addressing certain areas of commercial law. With respect to international trade in goods and services, Customs, immigration, and other border authorities are the chief implementing institutions. Problems uncovered in all institutions often relate to bureaucratic inefficiency, lack of resources and training, and, of paramount concern, real or perceived corruption.

Supporting Institutions. The indicators then look closely at the organizations, individuals, or activities that develop, implement, and enforce the legal framework and policy agenda. Examples include notaries, lawyers, banks, business support organizations (such as national, local, or sector-specific chambers of commerce) and private services, professional associations, universities, and the media. Questions examine the institution's relative awareness of law and practice, and the specific ways in which institutions increase public and professional awareness, work to improve the business environment, and otherwise serve their constituencies. In certain instances, weaknesses in one or more supporting institutions are identified as a critical area for reform. Changes such as the formation of a bar association or encouraging the media to cover an issue of critical public interest could support a push for reform.

Social Dynamics. Finally, the indicators consider relevant and critical social issues. These questions attempt to uncover roadblocks to reform, including entities that may have an interest in blocking change. These indicators also seek to identify significant opportunities for bolstering the business environment—such as champions of reform or regional initiatives—and expanding access to opportunity and strengthening formal institutions. A nuanced consideration of a country's social dynamics is often required for a full understanding of a country's legal and institutional issues.

The in-country portion of this diagnostic took place from June 4–15, 2007, when a team of commercial law and trade professionals traveled to Indonesia to closely examine its laws, public and private sector institutions, and social dynamics pertaining to commercial law and trade. The team members and topic area assignments were:

- Andrew Mayock (Team Leader)
- The Honorable Vince Aug (Commercial Dispute Resolution, Court Administration)
- Peter J. Baish (Flow of Goods and Services)
- Jonathan Conly (International Trade Law, Foreign Direct Investment)

- Joanne Cornelison (Flow of Goods and Services)
- Thomas N. Jersild (Company Law and Corporate Governance, Contract Law and Enforcement)
- Nicholas Klissas (USAID) (Real Property)
- James Newton (Flow of People, Intellectual Property)
- William Seas (Flow of Money, Financial Crimes)
- Allen Welsh (Secured Transactions, Bankruptcy).

Through a series of meetings with more than 100 public and private actors who participate in Indonesia's economy, and in concert with a comprehensive review of a wide array of documents relevant to the SEA CLIR Trade initiative, the team developed broad findings with respect to Indonesia's relative strengths, weaknesses, and opportunities. On June 15, 2007, the team conducted a roundtable discussion with representatives from the donor and diplomatic communities and received insights pertaining to its preliminary findings. This report summarizes the team's findings and includes recommendations for specific areas of reform. Although this report centers specifically on the commercial law and trade environment, its overriding purpose remains comparative, and it will be especially useful as the SEA CLIR Trade initiative compares the same set of issues in the other SEA CLIR Trade countries.

USAID conducted a similar review of Indonesia in 2003. A commercial legal and institutional reform assessment studied all of the topics reviewed in this report except for flows in goods and services, flows of money, flows of people, and intellectual property (IP).[3] That diagnostic did not take place in a regional context, but nonetheless provided important baseline empirical information for the common issues studied in the 2007 report. This report examines, among other key points of interest, the legal and institutional reforms that have taken place over the last four years. In certain areas – particularly corporate governance, financial crimes, competition, and banking institutions – significant reforms are taking root. In other areas, in particular the courts, change has been resisted or slow to take place.

Summary of Subject-Specific Findings

Company Law and Corporate Governance. In July 2007, following the conclusion of the in-country portion of this diagnostic, Indonesia replaced its 1995 Company Law. The new law revised or eliminated several of the prior law's obsolete provisions, in accordance with modern international best practices. The revision also allowed Indonesia to streamline its company registration and licensing processes, a step that is critical to reducing extreme levels of informality in the economy. Although the revision process also presented an opportunity to remedy the lack of publicly available information on companies, the final result does not incorporate all of the changes that might have been useful. Additional recommendations for reforming the new Company Law are presented in the Company Law chapter of this report.

[3] USAID/Booz Allen Hamilton, *Commercial Legal and Institutional Reform Assessment Report for the Republic of Indonesia* (October 2003), http://www.bizlawreform.com/country_assess/IndonesiaAssessment.pdf.

Contracts Law and Enforcement. Indonesia's contract law is comparable to the contract law established in other major commercial countries. It allows businesses to enter into agreements freely and seek justice from a court or other tribunal when necessary. However, contract enforcement can be so uncertain, unpredictable, and costly that the adequacy of the law itself has become meaningless. The poorly developed Indonesian court system causes these enforcement problems.

Real Property Law. The serious deficiencies of Indonesia's real property system, which include overlapping layers of state intervention and control, particularly affect poor and middle-class members of society. The Basic Agrarian law's pitfalls include granting too much discretion to government officials. Most civil society groups want the Basic Agrarian law to include clear protections of private land, but support for this type of change is not unanimous. In general, foreign and domestic investment suffers from the current state of real property law, and poor Indonesians cannot, under current circumstances, fully actualize or exploit their customary property.

Secured Transactions Law. The use of movable collateral to secure loans is a problem in Indonesia. A reported 31 percent of Indonesian small businesses do not apply for credit because they experience difficulties when asked to provide collateral.[4] If the secured transactions legal framework's many deficiencies (including unnecessary and burdensome bureaucratic procedures) were fixed, lender and debtor confidence in the use of secured transactions would increase. At this time, the Indonesian Fiduciary Guarantee Registry does not fill the role of a modern secured transactions registry. Among other problems, it does not provide the level of access to secured transactions information that potential lenders seek and require. While extensive legal and institutional reform is fundamentally needed, smaller steps that emphasize efficiency should be pursued immediately.

Bankruptcy. Although the legal framework for company insolvency is relatively sound, low levels of capacity and professionalism in implementing institutions hamper efficient administration of bankruptcy law. Judges, curators, and bankruptcy law administrators are challenged by simple tasks (such as recordkeeping) and basic principles (such as a commitment to public service). Therefore, creditors do not view these officials as honest brokers. Until substantial systemic reform is achieved and the letter of the law is realized, creditor claims will continue to be resolved through informal channels and some creditors will continue to exert excessive influence over others.

Competition Law. Notwithstanding laudable and important efforts to implement a sound competition law in Indonesia, a genuine culture of competition has been slow to take root. Many stakeholders and implementers do not fully understand the objective of competition law and policy, believing that its purpose is to protect individual business actors (particularly small and medium-size businesses) even at the expense of consumer welfare. Doubts about Indonesia's first independent competition agency's integrity and capacity have further contributed to a need

[4] The World Bank, *Revitalizing the Rural Economy: An assessment of the investment climate faced by non-farm enterprises at the district level.* 2006, Table 3.4, p.48.

for stakeholder education and engagement and clarification of the competition law's many ambiguities.

Commercial Dispute Resolution. The poor state of courts in Indonesia continues to encumber commercial relations. In disputes involving large sums, arbitration in Singapore is often preferred (even by the Indonesian government) as a formal settlement venue. In the smaller cases that affect the majority of economic actors, contract interpretation and enforcement is capricious and only a few experienced judges in Jakarta are regarded as honest and competent. Corruption and racketeering are overriding themes at every level. Judicial reform efforts are perceived as disorganized and short-lived, and there is often no way to determine who or what agency leads a program. Although there is growing public awareness of the importance of reliable courts and dispute resolution processes, deflecting the attempts at stifling reform of those who benefit from the current system will be a formidable obstacle to reform.

Court Administration. Almost universally, end users and outside observers agree that the courts are not an efficient, transparent, accountable, competent, or reliable venue for commercial dispute resolution. Future reforms should strengthen the role of the court clerk, improve the maintenance and use of information, increase transparency, and reinforce the entire system's commitment to reducing the opportunities for informal fees in the case process.

Foreign Direct Investment. Foreign direct investment (FDI) in Indonesia has begun to rebound since the Asian financial crisis. The resurgence can be attributed to the resumption of economic growth in the region and to legal and regulatory reforms in Indonesia that have improved the environment for foreign (and domestic) investors. Compared to pre-1997 levels, more investment in Indonesia now comes from Japan, China, Singapore, and other Asian countries than from Europe and North America. Impediments to attracting the level of FDI that would drive growth and employment to target levels include: an unstable policy and regulatory environment; an inconsistent approach to building an open economy; poor systems of commercial dispute resolution; an uncompetitive labor law; and rampant corruption at all levels of government.

International Trade Law. Since its recovery from the financial crisis, Indonesia has experienced little growth in trade: the value of its exports and imports has roughly kept pace with prices. Even the 33 percent nominal growth from 2004 to 2005 was due more to price increases in primary commodities than to growth in volume, indicating no real improvement in the competitiveness of the country's exports. Indonesia belongs to the World Trade Organization and has taken several steps to dismantle regulations that conflict with the terms of its membership. While the Minister of Trade and the ministry's secretary general are internationally respected free traders, other key implementers are not considered reformers, and public demand for trade liberalization has not been particularly high. In fact, international trade issues have a lower profile in Indonesia than they do in most ASEAN countries, and the imperative to drive growth through exports is not strong there—Indonesia leads the G-33, a retro-protectionist group.

Flow of Goods and Services. Government leadership in Indonesia, mindful of the importance of effective facilitation of trade at the borders, has developed a new Customs Law and appointed an efficient leader to manage the Customs department. The Customs department has made advances

in areas such as priority lanes, risk management, and post-release auditing. However, automation remains a significant problem, and it is not yet clear if the new law will be properly implemented. Corruption at the border still exists. Challenges confronting the trade community in Indonesia include a lack of interagency coordination, poor access to credit, inadequate infrastructure, and high labor costs.

Flow of Money. The financial crisis of the late 1990s affected trade through diminished appetite for risk and increased scrutiny of bank balance sheets, which almost eliminated the private sector's involvement in providing financial products and services to facilitate trade. Ten years later, the sector has made considerable progress toward constructing a sound regulatory environment and a supervisory framework that raises the confidence of domestic and foreign investors. This has led to growth in the financial sector's ability to facilitate trade through many of the traditionally recognized international mechanisms. But the providers are few, the costs are high, and market coverage is minimal. Overall, Indonesia is developing a more sophisticated and diversified financial system that will improve access to longer-term capital, increase small and medium-size businesses' access to credit, and generate product and service innovations that meet the needs of businesses that conduct international trade.

Flow of People. The flow of people in, out, and through Indonesia is adequate to meet current business needs, but additional improvements are required. The country's immigration-related legal framework meets international standards, but associated institutions and processes are cumbersome and inefficient.

Financial Crimes. Placement on the Financial Action Task Force's list of Non-Cooperative Countries and Territories in 2001 spurred Indonesia to construct a more effective regime to combat money laundering and terrorist financing. In 2002, Indonesia adopted key legislation that has served as the foundation of its multi-faceted effort to build the legal framework and enforcement capabilities needed to reduce the country's attractiveness to lawbreakers seeking a financial crimes haven. Indonesia has made considerable progress in formulating and passing legislation that is generally consistent with international best practices, but weaknesses persist in the area of law enforcement.

Intellectual Property. Indonesia has begun to keep pace with the profound changes taking place in the field of intellectual property rights protection. In the past decade, the country has adopted numerous standards that have strengthened its domestic legal framework. However, Indonesia continues to lag behind other countries in the implementation of these standards, rating poorly in important measures such as quantities of pirated goods. This situation has reportedly resulted in diminished interest in the country on the part of foreign investors. Beyond the establishment of the legal framework, and despite a number of well-intentioned efforts, public and private institutions have not successfully improved intellectual property rights protections or raised awareness about the issue.

Cross-Cutting Themes in Legal and Institutional Reform

In the course of this diagnostic, the following cross-cutting themes emerged with respect to CLIR and trade in Indonesia:

- The state of the informal sector is insufficiently understood and under-appreciated as a drag on future economic growth.
- The quality of business-related information is insufficient to meet the demands of a dynamic economy.
- Indonesia's corps of professionals—lawyers, judges, economists, accountants, etc.—are insufficiently trained in the tools of a modern economy and are insufficiently organized to influence policy in the future.
- Corruption will continue to demand aggressive solutions at the lowest and most persistent levels.

This section discusses these themes.

a. The informal sector

Indonesia abounds in commercial sector reform efforts that aim to bring the country into compliance with international best practices. But most of these reforms—in Company Law, competition policy, corporate governance, banking and access to finance, trade facilitation, etc.—are directed at a segment of the economy to which many, and perhaps most, enterprises do not even belong: the formal sector. To benefit from many of the legislative protections currently under construction an enterprise must be legally recognized by the state. Legal recognition begins with company registration (as detailed in this report's chapter on Company Law), which signals a willingness to comply with tax and licensing requirements, labor and employment law, land use and zoning rules, and other regulations. In return, an enterprise that registers with the state is granted the protection of limited liability.

Limited liability is an obscure benefit in the eyes of most small entrepreneurs, and the consequences of registration—the regulatory hassles and the taxes—do not seem worth the price.

But limited liability is an obscure benefit in the eyes of most small entrepreneurs, and the consequences of registration—in particular the regulatory hassles that most businesses in the formal economy face and the taxes they must pay—do not seem worth the associated costs and effort. As a result, Indonesia has a massive informal sector whose components are both visible and hidden.

In the street, small-scale entrepreneurship is obvious in an abundance of services and products for sale, from messenger services to tiny restaurants to stalls that sell produce, hardware, and household goods. Behind closed doors, Indonesian industrial entrepreneurs reportedly employ mostly female workers at very low wages in unsafe conditions. Although street vendors and tiny service-oriented businesses are the most visible informal players, more modern enterprises, including supermarket chains, auto parts suppliers, consumer electronics assemblers, and even large-scale industrial operations, can also use informal employment tactics.[5] Interviewees reported that the "overwhelming majority" of Indonesian businesses do not register with the state, that a great many of these informal businesses are operated by women, and that regulatory hassles from municipal and other agencies make operation in the shadows preferable to joining

[5] *See* Diana Farrell, *The Hidden Dangers of the Informal Economy*, McKinsey Quarterly, Vol. 3, 2004.

the formal economy. In spite of the widespread presence of "shadow" enterprises throughout rural and urban Indonesia, there has been no recent, clear, or reliable assessment of the extent of this presence. Various estimates of informal enterprises as a percentage of Indonesian GDP range from 19.8 percent[6] to 38 percent[7] to 75 percent.[8]

What is clear is that high rates of informality in an economy are associated with poverty:

> [Workers] enjoy no social benefits and cannot use pension plans and school funds for their children. Businesses do not pay taxes, reducing the resources for the delivery of basic infrastructure. There is no quality control for products. And entrepreneurs, fearful of inspectors and the police, keep operations below efficient production size.[9]

When enterprises elect not to register, the state suffers in terms of sanitation, health, safety, prosperity, and productivity.[10] In addition, unregistered enterprises are unable to borrow money from formal credit institutions and are unable to take advantage of many attractive investment opportunities. The products of unregistered enterprises are often of substandard quality and limited variety, and consumers are offered little protection in the event of malfunctioning products.[11] Where rates of business informality are high, merchants may feel compelled to pay "protection money" to powerful local actors for the right to operate their unsanitary or non-tax-paying businesses.

Businesses that have registered with the state and chosen to satisfy their legal obligations suffer in terms of profitability, productivity, and opportunity when forced to compete with businesses that have not chosen the formal path.

Finally, businesses that have registered with the state and chosen to satisfy their legal obligations suffer in terms of profitability, productivity, and opportunity when forced to compete with businesses that have not chosen the formal path.[12] In fact, everyone loses when enterprises refuse to pay taxes, because when the Indonesian government does not receive sufficient tax receipts, it may choose to raise taxes on those businesses that are already complying with the law, thus increasing the chances that other businesses will choose to remain informal.[13] This diagnostic found that Indonesia has made almost no investment in power generation, roads, or port capacity since the financial crisis. Inadequate infrastructure continues to constrain operating efficiencies and discourage investors. Although the government plans to increase infrastructure spending in 2008, its available resources are diminished due to the country's pervasive economic informality.

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[6] Friedrich Schneider, *Size and Measurement of the Informal Economy in 110 Countries around the World* (paper presented at workshop of the Australian National Tax Center at the Australian National University on July 17, 2002), p. 3-4.

[7] Kristina Flodman Becker, *The Informal Economy* (World Bank, 2004), p. 31 (citing a 1998 figure).

[8] GreenLeft online at http://www.greenleft.org.au/2005/640/33889, material dated 2005.

[9] World Bank, *Doing Business in 2004*, p. xv.

[10] Farrell, "Hidden Dangers."

[11] United Nations Development Programme, *Unleashing Entrepreneurship, Making Business Work for the Poor*, 2004, p. 12-14.

[12] Farrell, "Hidden Dangers," p. 31-32.

[13] Ibid.

The World Bank recently identified increasing non-farm productivity as a key priority for reducing poverty in Indonesia.[14] In the absence of a targeted endeavor to understand and address the roots of informality, increased productivity in Indonesia will remain elusive:

> The notion that informal companies might grow and become more productive is unfounded. They can't borrow from banks or rely on the legal system to enforce contracts or resolve disputes, and they structure relationships with informal suppliers in ways that make it difficult to come clean. In fact, informal companies often shun opportunities to grow and modernize precisely so they can continue to avoid detection. As a result, informal businesses remain a persistent drag on national productivity and living standards.[15]

Measures that would encourage entry into the formal sector:

- Improving outreach and information provided to new and small entrepreneurs.
- Reducing registration fees and costs (especially those associated with notary services
- Eliminating minimum capital requirements.
- Reducing and simplifying taxes.
- Abolishing all unnecessary or duplicative regulations.

Thus, while Indonesia endeavors to strengthen its legal regime in support of long-term economic growth, there is an equal need for comprehensive efforts to increase the rate at which enterprises join the formal sector so that they can benefit from these reforms. Indonesia has used assistance from the Asia Foundation to streamline certain regulatory and licensing requirements through "one-stop shops," but additional required steps include: improving outreach and information provided to new and small entrepreneurs; reducing registration fees and costs (especially those associated with notary services); eliminating minimum capital requirements; reducing and simplifying taxes; and abolishing all unnecessary or duplicative regulations.[16] Special effort should be made to understand and address the presence of a large percentage of women in the informal economy. Until the rate of formalization increases, the informal economy in Indonesia will limit the increase in productivity that the country desperately needs.

b. The need for more, better, and more accessible information

The absence of reliable information pertaining to the private sector undermines the entire Indonesian economy and diminishes productivity and the potential for growth. Rather than having adequate amounts of easily accessible data about company characteristics, credit information, collateral registration, court records, and trade, Indonesia has scant information that is difficult to access. Among the critical information accessibility problems found in this diagnostic are:

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[14] World Bank, *Making the New Indonesia Work for the Poor*, 2006, p. xv.

[15] Diana Farrell, "Boost Growth by Reducing the Informal Economy," *Asian Wall Street Journal* (October 18, 2004).

[16] Louise D. Williams, "Out of the Gray: Building the Case and the Conditions for Enterprises to Join the Formal Economy in Central America," 12 *Southwestern Journal of Law and Trade in the Americas* (2006), p. 329 and 365–369.

- There is a serious shortage of **public information about companies**, especially non-stock exchange companies, and what does exist is not easily accessible. Even the information contained in a company's filed Articles is sometimes treated as "confidential" by the company registry and not made available without the company's permission.
- It is extremely difficult to obtain information about **ownership and other interests in real property** (i.e., liens, mortgages, and easements) through the land registry, which refuses to provide that information to anyone but the landowner.
- The collateral registry's records are not useful to prospective creditors and buyers of collateral who need information on the **status of a debtor's property.** Because all security agreement information is entered by hand in the ledger, prospective creditors must either search each ledger entry manually for conflicting fiduciary guarantees or examine each of the file folders containing the original applications and supporting documentation. These burdensome and time-consuming requirements discourage lending.
- **Court records** are difficult to access and often cannot be retrieved without written permission from an unspecified number of judges. Courts do not harness the storage potential of their computers, generally using them for word-processing functions only.
- In bankruptcy proceedings, creditors have difficultly receiving information about a **company's assets and liabilities** from the court-appointed bankruptcy curator.
- At borders, **trade data** is not effectively maintained.

Open, competitive economies require free flows of information that decrease the risks of doing business. Access to public information should be encouraged and facilitated rather than discouraged. Indonesia should institute measures that encourage better recordkeeping about commercial activity and find inexpensive ways to make that information available to people who need it.

c. Building and organizing a corps of professionals to meet the demands of a global economy

A paper-and-pencil, insular economy cannot meet the current demands of the global economy. In all aspects of commerce, the presence of technology and the needs of international trading partners raise the worldwide expectations of Indonesia's institutional capacities. One cause of the financial crisis of 1997 was the mismatch between the sophisticated transactions already taking place and the lack of sophistication of the professional class.

Indonesia is still struggling to develop a corps of professionals that is sufficiently capable to administer an open, competitive economy. The country has increased the quality and range of topics covered in law schools, which now offer courses on topics such as secured lending and competition. Institutions like the Intellectual Property Center at the University of Indonesia will contribute to public dialogue about Indonesia's standing on important global issues. However, these small steps forward have not been sufficient to create the large numbers of trained professionals that are required to drive economic transformation. Persistent issues include:

- Continuing education opportunities that would bolster the ability of **judges** to manage economic cases are not widely and routinely available. Although various donor-funded projects deliver judicial training, many judges are still unfamiliar with modern commercial law.
- Because of the tendency in Indonesia to regard **court clerks** as second-class staff, these workers have been largely excluded from the court reform process and from continuing education in administration and substantive law. Predictably, the job performance of court clerks has not improved.
- In the area of bankruptcy, creditors complain that **curators** (administrators) are insufficiently qualified. Although must curators receive legal training at Indonesian law schools, they are not trained in accounting or business management.
- **Legal professionals**, including lawyers, prosecutors and judges, lack experience with financial crimes, and Indonesia suffers from a general shortage of **accountants and auditors**.

The dearth of continuing education opportunities for professionals is compounded by general weaknesses in supporting institutions. For example, Indonesian bar associations do not provide meaningful training for their members or regulate professional standards or ethical conduct. Many of the competition-related associations formed in 1999 with the passage of the new competition law have since dissolved or become inactive due to lack of funding or frustration with the progress of competition policy implementation in Indonesia. In the area of international trade, associations have been hobbled by low membership and problems with dues collection. Many trade firms, fearful of losing their competitive advantage, are reluctant to fully engage in a collective framework to solve problems and discuss pending legislation because they do not wish to share confidential business data.

In the area of international trade, associations have been hobbled by low membership and problems with dues collection. Many trade firms, fearful of losing their competitive advantage, are reluctant to fully engage in a collective

Academic programs must be strengthened, opportunities for continuing education must be increased, and the organizational capacities of professional, trade, and industry groups must be bolstered in order to create a more prepared and responsive Indonesia economy.

d. Petty corruption: Tackling cynicism and bad habits

Credit where credit is due

This diagnostic identified a number of areas where Indonesia has exhibited significant will to reform and implemented changes that show real results. Examples include reform in the following areas:

In banking and finance. Indonesia has constructed a sound regulatory environment and a supervisory framework that raises the confidence of domestic and foreign investors. Basic trade finance products are becoming more widely available to traders, and foreign currency exchange is broadly available and fairly easily exchanged.

In corporate governance. Working under the auspices of the Ministry of Economic Affairs, the National Committee on Governance issued Indonesia's new Code of Good Corporate Governance in 2006 (after extensive public consultation). Although not legally binding, it sets guidelines that companies are strongly encouraged to follow; non-compliant companies are intended to be "shamed" in the market.

In competition. Indonesia has moved forward in implementing one of the most progressive competition regimes in the region and showed leadership in getting the issue of competition on the ASEAN agenda.

In cross-border trade. The Directorate General for Customs and Excise has made numerous improvements in the movement of goods across borders, in particular through increased responsiveness, innovative programs directed toward high-compliance communities, and reduced corruption.

In protecting intellectual property rights. Indonesia has become a contracting party to a number of international instruments. It has passed new laws on copyright, trademarks (including geographical indicators), patent, integrated circuits, industrial design, trade secrets, and protection of plant varieties. It also repealed many of the prior laws that did not conform to international standards.

In combating financial crimes. Indonesia has formulated and passed legislation that is generally consistent with international best practices.

Indonesian leaders have acknowledged the importance of reducing corruption and have taken a variety of related steps, including establishing the Commission to Eradicate Corruption, the Anti-Corruption Court in Jakarta, and new codes of conduct for various government officials (including judges). They also have begun to encourage better standards of corporate governance. Yet the tradition of informal "transaction fees" is so entrenched at the lowest levels in so many institutions—the courts, the Customs department, various registries, and large corporations—that it will likely take at least a generation to restore public confidence in the health of the overall system.

In general, average citizens, businesspeople, and many service professionals pay informal fees when engaging in legal or trade-related activities. Lawyers frequently circumvent the established administrative processes by paying unofficial "speed money" to court clerks to ensure that their clients' cases are handled quickly, arguing that this bribery is ethical because it saves their clients money and forces the court system to work efficiently. At borders, traders accept that they will have to pay unofficial fees government officials, including the policeman on the highway, the gate attendant at the port, the port worker who loads and unloads cargo, and the Customs officer who moves the paperwork. All of this petty corruption slows Indonesian commerce.

A campaign of small, low-cost efforts to diminish petty corruption—e.g., signs posted in clerk's offices bearing the warning, "Failure to give a receipt for any court fee is a criminal offense and should be immediately reported to the police"—could make a difference, but they will not be implemented until leaders acknowledge the problem of petty corruption. Then, private actors must agree to refrain from enabling corrupt practices. On this front, stronger supporting institutions could help raise expectations from service professionals like lawyers and brokers.

COMPANY LAW AND CORPORATE GOVERNANCE

Introduction

On July 22, 2007 (after the in-country portion of this assessment was completed), Indonesia replaced its 1995 Company Law with a revised version. The revision process offered an opportunity or eliminate obsolete provisions in the old law and to add new provisions for investor protection following international corporate governance best practices. The revision process also presented the chance for Indonesia to streamline its company registration and licensing processes.

The new law accomplished this to only a very limited extent. However, it established a new body of "Company Law Monitoring Experts" with authority to review the law on a continuing basis. Specific suggestions for revision of the new law, for consideration by that body and others in Indonesia, are made below.

Corporate governance, critical to attracting domestic and foreign investment, has become a high priority worldwide and in Indonesia. Actions taken to date include new company-rating and director-training programs for public companies and the issuance of a new national Code of Good Corporate Governance (which has yet to implemented and enforced).

Legal Framework

Until the enactment of the new Company Law, the 1995 Company Law (Law 1/1995, On Limited Liability Companies) governed all publicly registered commercial companies. That Company Law was supplemented by a 1996 Capital Market Law (Law 8/1996, On the Capital Market), which applies to public companies[17] and governs Indonesia's stock exchanges and the stock exchange and securities regulatory agency (known as "BAPEPAM" and called the Capital Market Supervisory Agency in English). Separate rules for corporate governance are set forth in BAPEPAM's regulations and in a new 2006 Code of Good Corporate Governance.

Separate from the Company Law, the Indonesian Civil Code and Commercial Code provide for three consensual businesses forms that are similar to partnerships in other countries. These forms are not publicly registered and they do not provide their owners with limited liability, although one form, the CV (named from the abbreviation of the name in Dutch, and which is similar to a limited partnership in other countries) provides limited liability to its sleeping (limited) partners but not to the partners who actively participate in management.

[17] Companies with publicly traded stock or 300 or more shareholders.

The Company Law. The new law updates and expands upon the 1995 law, but is in many respects the same. The main features of the new and old laws are summarized below. Numbers refer to Articles in the new law.

- There is one form of company, called a Perseroan Terbatas, or "PT."
- There is no separate, more flexible form of company for small and closely held businesses. In this aspect the law differs from those of many major commercial countries.
- A company must have at least two shareholders (7). In practice, a husband and wife are counted as one for this purpose. This rules out single-owner companies and wholly-owned subsidiaries, which are common in businesses worldwide, and it rules out mom-and-pop companies. Other major commercial countries' laws allow one-shareholder companies.
- Under the 1995 law, a company was required to have capital of at least 20 million rupiah (about US$2,200); this was increased to 50 million rupiah (about US$5,500) in the new law. Several countries, like the United States, have eliminated capital requirements entirely, while others have retained them for publicly traded companies but eliminated them for non-public (small and closely held) companies.
- A company must have two boards: (1) a Board of Directors that is responsible for management or supervising management; and (2) a Board of Commissioners that oversees and advises the Board of Directors. Both are elected by the shareholders.
- Under the 1995 law, a company may issue bearer shares (1995 law 24, 49). The new law refers only to shares whose ownership is registered with the company (50), which appears to mean that bearer shares are no longer permitted. That would be a positive change, because bearer shares can be used to hide ownership, enable tax evasion, and facilitate theft and forgery of share certificates.
- A company may issue multiple classes of shares with different voting rights (53). The "one share equals one vote" principle governs unless the company itself decides otherwise, which it is free to do (82).
- A company must hold an annual shareholder meeting within six months after the end of its fiscal year (76), and shareholders holding 10 percent or more of the voting power may require other shareholder meetings (77).
- Regarding fiduciary duties, the new law imposes a duty of "good faith and full responsibility" on members of the Boards of Directors and Commissioners (95, 111) and states that they "shall be personally fully liable for the company's losses if the member concerned is at fault or negligent in carrying out his or her duties" without good faith and responsibility. The new law adds a version of the "business judgment rule," stating that a director or commissioner is not liable for business decisions made in good faith without any personal conflict of interest (95, 111).
- The law does not state other standard fiduciary duties (such as the duties of, loyalty, non-competition, and non-appropriation of inside company information or business opportunities) and it does not impose fiduciary duties on officers, senior managers, or controlling shareholders. Nor does it have provisions governing and restricting conflict-

of-interest transactions between a company and its directors, commissioners, and other such persons.

- Shareholders having at least 10 percent of voting power may sue a member of the Board of Directors or Commissioners derivatively who "due to his fault or negligence causes losses to the company" (95, 111). As in most of the world, these lawsuits are extremely rare in Indonesia.

Profile of Indonesian companies. The vast majority of Indonesian companies are family-owned or otherwise closely owned. Most of these companies are small, and many are very small, but some are very large. Many small and medium-size businesses are not registered PT companies but are sole or family proprietorships. Those businesses have little motivation to join the formal economy through registration and compliance with the regulatory framework for a variety of reasons. Limited liability has little meaning for a small operation that faces little threat of a court lawsuit. Municipal units are reportedly the main regulatory body for these businesses; small enterprises (registered or not) often live in fear of local municipal authorities "hitting" them for alleged infractions of local rules and bribes. Examples cited include cases in which equipment or inventory was taken or damaged by officials as a preface to negotiation of "special payments." Interviewees further stated that many small businesses find that living with the repercussions of informality is preferable to the "hassle" (in time and cost) and uncertainty concomitant with official registration as a PT company.

Many important companies are owned or controlled by governmental bodies, which adds a political tone to doing business. State-owned enterprises are not organized under the Company Law and thus are not subject to its rules and protective provisions. However, certain provisions of the Company Law do apply to state-owned companies, although state-owned companies are also regulated by separate laws and regulations on specific issues. For example, state-owned banks are governed by both the Company Law and the Banking Law.

Company startup: registration and licensing.

(1) Initial company registration. This "company creation" step has been simplified in Indonesia but is still more costly and cumbersome than in other major commercial countries. Under the best circumstances the process takes weeks. Furthermore, a company's founders cannot register a company themselves, but must engage a notary and pay the notary a fee. This is the process, as described by respondents:

- Execute the Articles of Association, which take the form of a notarial deed prepared by a notary before whom the founders must appear in person or by proxy.
- Obtain a separate "domicile letter" (which states among other things the directors' names and birth dates and the initial number of employees) from the local sub-municipal government unit (the *lurah*) in which the company is to be located. This can accomplished without a notary.
- Apply for and obtain tax registration from the tax office.
- Deposit the required capital in a bank and obtain a bank receipt showing proof of deposit.

- Send the notarized Articles and other items for review to the company registry in the Ministry of Law and Human Rights. This step must be completed by a notary via mail or e-mail.
- Await a response.[18]

According to respondents, even under the best circumstances, obtaining the initial registration certificate takes about 14 days; a Ministry of Trade certificate takes about another 14 days; and a total of about two months is needed to see the process through to completion with *Gazette* publication.[19] Fees and costs vary depending on the size and capital of the company. The notary's fee ranges from seven to 12 million rupiah (about US$800 to $1,300 even for the smallest company).

The notary in civil law countries: a role that has outlived its usefulness?

Some constituencies consider the notary to be an inviolable part of the civil law tradition. The World Bank's *Doing Business in 2004* investigation into the actual effectiveness and value of the notary in the business environment, however, call into question the position's relevance and utility:

> Why do some countries still have notaries involved in business registration? . . . The Papacy saw a good source of income in notarial services and made notaries papal administrators. Notaries quickly lost their importance in England in 1534, when Henry VIII broke from the Roman Catholic Church and made it a criminal offense to apply to the Vatican for a notarial appointment. In contrast, notaries retained their role in France, Spain, and Italy. Colonization ensured their existence in many countries around the world.
>
> The service a notary provides—checking the identity of company founders and company officers—is routinely performed by public administrators for many other services. And clerks at the business registry are as able as notaries to confirm identities.

(2) Further permits and licenses. Additional approvals are needed to operate in major business sectors such as trade, industry, and tourism, and other mandatory approvals are needed for a long list of particular products and activities, including construction, transportation of certain products, operation of industrial equipment, specific tourism activities (such as water tourism), production of specific commodities, and export of certain products.

Every respondent stated that the process for obtaining these approvals can be lengthy, unpredictable, and expensive. Some licenses are clearly justified for health or public safety

[18] Following review, the Ministry accepts or rejects the filing. If it accepts, hard copies of the electronically-sent documents must then be filed physically. The Ministry issues a certificate that is sent either to the Ministry of Trade (if the new company is a trading company) or the Ministry of Industry (if it is an industrial company). The relevant Ministry then stamps the certificate, registers the company, and issues a certificate with a company registration number. The company's registration must be then published in the *Gazette* by the notary.

[19] It should nevertheless be said that it is now quicker than reported for Indonesia in the World Bank *Doing Business 2007* Report, which lists a time for "starting a business" of 97 days with 12 procedures required, giving Indonesia a ranking on this point of 161st of the 175 countries surveyed. The Bank report does not give enough detail to allow a comparison with the description above. However, there has clearly been some improvement, and that point was made by respondents.

purposes, but many have no apparent public purpose. There is no standard form or uniform procedure; each agency has its own often unpublished and opaque rules and approach, and the agencies do not always communicate with each other. This problem is exacerbated by the decentralization of Indonesian government powers begun in the 1990s, which divided responsibility among the national government and district, sub-district, municipal, and sub-municipal bodies whose respective jurisdictional boundaries are often unclear. Some approvals are required as a precondition for a company's initial registration, which means that a startup business cannot register as a PT and take normal organizational steps until it has received those particular approvals.

The cumbersome licensing regime is not a newly discovered problem. In the late 1990s the national government established local "one-stop shop" centers to coordinate licensing activity in some parts of the country (although it did not establish a national center). The Asia Foundation has also initiated a major project to streamline licenses. The scope of the problem and an account of the successes and failures of the government's reform efforts are analyzed in an April 2007 report by the Asia Foundation.[20]

Information on companies. The importance of public access to company information as a means of strengthening the business environment is not well understood in Indonesia. There is a serious shortage of public information and data on Indonesian companies, especially non-stock exchange companies, and what does exist is not easily accessible. Even the information contained in a company's filed Articles (e.g., address for delivery of notices, names of directors and commissioners, names of founders, number of shares, and rights of each class of shares) is sometimes treated as confidential by the registry and not made available without a company's permission. It is not possible to obtain, for example, breakdowns of all companies by: type of business (such as by industrial classifications as used in the United States); size (by any rough measure such as capital, total sales, or number of employees); number of shareholders; number of companies that are foreign-owned vs. domestically-owned; number of companies that are linked in common ownership; or names of company directors. That type of data is publicly available in other countries because potential investors want and need it. The absence of this information makes Indonesia less attractive to domestic and foreign investors and potential lenders.

Corporate governance. As noted above, the Company Law does not lay out fiduciary duties in any detail. The nearest thing to a set of mandatory best-practices is found in the very helpful rules issued by BAPEPAM. These rules function as requirements for companies on the two stock exchanges:

- A very strict provision that requires approval by disinterested shareholders of conflict-of-interest transactions between a company and any director, commissioner, or major

[20] Asia Foundation, *Making Sense of Business Licensing in Indonesia: A Review of Business Licensing Policy and Survey of One Stop Shop Licensing Centers* (2007). The World Bank also addressed the issue in its *Doing Business in 2007 Report*, which, under the heading "Dealing with Licenses," reported a time period of 224 days and 19 procedures, ranking Indonesia 131st of the 175 countries surveyed. Some respondents commented that the reports figures are too low, and that the process typically takes longer.

shareholder (Rule IX.E.1, issued under the provision of the Capital Market Law on this subject, Article 82).

- A rule requiring public disclosure of ownership changes by directors, commissioners, and shareholders who hold more than five percent of the company (including price paid for their stock) (Rule X.M.1).
- Rules for holding shareholder meetings and publishing their minutes (Rule IX.I.1) and rules for mandatory, publicly-available company annual reports with detailed management reports and financial statements (Rule VII.G.2).
- A rule requiring an independent audit committee of the Board of Commissioners with broad and detailed meeting requirements, authorities, and reporting responsibilities (Rule IX.I.5).

BAPEPAM's rules also require public filing and disclosure (and availability to the public in the Capital Market Reference Center) of corporate documents of public companies, the stock exchanges, clearing and guarantee institutions, and a central securities depository (Rule II.A.1). They also contain general provisions for fines and other enforcement (including cease and desist orders) for violations (see Rule XIV.B.1 and the above-cited audit committee rule).[21]

Many of BAPEPAM's rules are several years old (for example, the conflict-transaction rule dates back to 2000) and there appears to be no regular process for their revision and updating. They have also not yet been adapted to incorporate many of the principles stated in the new corporate governance code.

Indonesia's new Code of Good Corporate Governance was issued in 2006 (after extensive public consultation) by the National Committee on Governance working under the auspices of the Ministry of Economic Affairs. This code is an important national document. Although it is not legally binding, it sets guidelines that companies are strongly encouraged to follow; noncompliant companies will be "shamed" in the market.[22] The code's contents illustrate its scope and its commitment to international best practices. The code:

- Outlines its context and background, referring to the Organization for Economic Co-operation and Development (OECD) Principles of Corporate Governance and the U.S. response to the Enron and WorldCom scandals
- Describes the monitoring and enforcement roles of Indonesian regulatory and enforcement bodies and business and market participants

[21] This is under authorities granted to BAPEPAM in the Capital Market Law, which include general authority to investigate companies, suspend trading in or delist a company's stock, initiate criminal investigations, and impose administrative penalties (Articles 3–5 and 100–110). The Capital Market Law also requires the stock exchanges to issue listing rules and empowers them to make surprise inspections for compliance (Articles 9–12).

[22] More than 30 other countries have also issued corporate governance codes as non-binding guidelines on this principle. The best research source for these is the website of the European Corporate Governance Institute, www.ecgi.org. That site does not yet include the new Indonesian Code, but it is on the National Committee on Governance website, http://www.governance-indonesia.com/content/view/88/1/lang,en/.

- Details the governing principles of transparency, accountability, independence, and fairness
- Establishes specific rules for business ethics, conflict of interest transactions involving company controlling persons, and encourages whistleblower programs and protections within a company
- Establishes rules governing the roles of: the shareholder meeting; the Boards of Directors and Commissioners; and the boards' audit, nominating, remuneration, and risk policy committees, and requirements for both boards to make accountability reports
- Details certain minority shareholder rights and controlling shareholder responsibilities
- Details rights and the role of other "stakeholders," including employees, suppliers and other third parties, and the community.

Implementing Institutions

Ministries. The **company registry** is part of the **Ministry of Law and Human Rights**, the successor to the former Ministry of Justice. **BAPEPAM** is accountable to the **Ministry of Finance.** The **National Committee on Governance** operates under the **Ministry of Economic Affairs.** The National Committee on Governance, with more than 20 members, represents a broad range of interests at high levels, and members and contributors to the Code of Good Corporate Governance included representatives of BAPEPAM, the stock exchanges, banks, the Indonesia Chamber of Commerce, the Indonesian Accountant Association, law firms, university faculties, and the corporate governance organizations identified below. The new code replaces a 2001 version that was prepared with help from donors (including USAID). The new code was funded and prepared through Indonesian institutions only, which is a positive development.

The **Ministries of Trade and Industry** have a role in company registration as described above, and they and numerous other ministries grant permits and licenses to companies.

License and permit bodies play critical roles in company startup. These organizations include ministries, numerous regional, district, and municipal bodies, and (in some cases) private organizations.

BAPEPAM and the stock exchanges. BAPEPAM is the primary capital market regulatory agency with supervisory authority over the public-company securities markets and the two stock exchanges.[23]

Indonesian Investment Coordinating Board. This agency grants investment licenses to domestic and foreign investors. It also promotes investment in Indonesia and is an active and useful information source and advocate for private companies and investors. It could be the locus of a future national "one-stop shop" that would oversee the licensing process.

Courts. In theory, the courts are the ultimate legal recourse for resolution of company and other business disputes. This broader topic is covered in the "Commercial Dispute Resolution" section

[23] BAPEPAM's website is www.bapepam.go.id. The Jakarta Stock Exchange website is www.jsx.co.id. The regional Surabaya stock exchange website is www.bes.co.id.

of this CLIR report. However, on the specific subject of Company Law, respondents remarked that courts are "avoided whenever possible" because they are slow to decide, costly and cumbersome, sometimes hard to locate physically, and uneducated in company and business matters. Most respondents also complained of corruption in the court system. One person noted that special payments, rather than court costs, make litigation too expensive for potential litigants to consider as a viable option.

Other dispute resolution bodies. Arbitration and mediation are not often used as alternatives to the courts. The unavailability (or non-use) of local independent dispute resolution mechanisms is a sorely missed opportunity for business dispute resolution in Indonesia.

Supporting Institutions

Lawyers and other professionals. Many private lawyers, law firms, and accounting firms provide advice on company organization, structuring, and corporate governance, especially in Jakarta. Due to funding and organizational issues, the major Indonesian bar association, the **Indonesian Advocates Association**, it is not currently as active as it could be or as bar associations are in many other countries.

The Company Law Monitoring Experts body. As noted in the introduction, the new company law established a broad-based body of professionals whose mandate would include further and continuous review of the new company law and corporate governance matters. Its exact assignment and organizational structure are to be detailed in a future Ministerial Decree. This is an important body that will include persons who have given attention to all of the issues discussed above.[24]

Private and quasi-private corporate governance organizations. Many diverse organizations are positively shaping and monitoring corporate governance in Indonesia:

- The **National Committee on Governance:** (1) helped develop the Code of Good Corporate Governance, (2) issued a code for banks and guidance for audit committees and independent commissioners, and (3) held workshops in the past year on board duties and responsibilities. These initiatives are described on the committee's website at www.governance-indonesia.or.id.

[24] This new body is created by Article 156 of the new company law which should be quoted:

"(1) In the frame of the implementation and development of this law a team of Company Law Monitoring Experts is established.

(2) The membership of the team referred to in paragraph (1) shall consist of the following:
government
experts/academicians
profession; and
business.

(3) The expert team has authority to review the deed of establishment and the amendment to the articles of association based on the team's own initiative or at the request of a stakeholder, and provide opinions on the results of the review to the Minister.

(4) Further provisions on the competence, organizational structure and working system of the expert team shall be governed by a Ministerial Decree."

- The **Indonesian Institute of Corporate Governance** (www.iicg.org) publishes comparative ratings of company corporate governance in its annual "perception index." Twenty-six companies (22 of which are publicly traded) participated in the most recent index, which is conducted on a voluntary basis. Interviewees stated that at least one company publicly advertises its high rating.
- The **Indonesian Institute for Corporate Directorship**'s Professional Director Program provides corporate governance training and has certified more than 100 people (www.iicd.or.id).
- The **Forum for Corporate Governance in Indonesia** holds frequent programs and publishes a monthly corporate governance newsletter (available at www.fcgi.or.id). Its activity sponsors include ABN Bank and PriceWaterhouseCoopers.

Donors and NGOs. USAID and the Asia Foundation have supported company licensing and court administration reform efforts. We were unable to interview other donors about their Company Law and governance projects due to time constraints.

Notaries. In Indonesia, notaries play a larger role in company operations than in almost any other country. A notarial deed is required for registration documents and many company resolutions, for instance. Some people believe that the notary's level of involvement is unnecessary and unnecessarily costly.

Social Dynamics

The problem of informality. Despite considerable efforts to improve the environment for starting a company and to improve governance of existing companies, the rate of informality in the Indonesian economy remains among the highest in the world.[25] Various estimates of informal enterprises as a percentage of Indonesian GDP range from 19.8 percent[26] to 38 percent[27] to 75 percent.[28]

Because it is not fully understood, the problem of the gray economy in Indonesia cannot be effectively tackled. An analysis of the actual rates and specific drivers of informality is urgently required. Special studies of the following topics should also be conducted:

- The extent of informality at the non-micro level (i.e., businesses of 10–100 employees)
- The similarities and differences between informality in the urban and rural sectors
- The presence of a large percentage of women in the informal economy.

Improvements to the company registration processes would not greatly affect—and are not really aimed at—enterprises in the informal sector. More streamlining of the company registration

[25] Edi Suharto, *Human Development and the Urban Informal Sector in Bandung, Indonesia: The Poverty Issue,* 4 New Zealand Journal of Asian Studies 2 (December 2002).
[26] Schneider, *Size and Measurement of the Informal Economy in 110 Countries around the World*, pages 3-4.
[27] Becker, *The Informal Economy.*
[28] GreenLeft online.

process would make it easier for small businesses to register as PT companies, but the problem of motivation remains unaddressed. They still face a diffused, complex, and subjectively administered regulatory and licensing system that discourages them from joining the entrepreneurial formal economy of larger companies.[29]

Corporate governance. As in many other countries, corporate governance in Indonesia is imperfect, and changing old habits takes time. The World Bank's 2004 *Report on the Observance of Standards and Codes (ROSC)—Corporate Governance Country Assessment—Republic of Indonesia* found that Indonesia *fully observed* none of the 23 OECD principles/sub-principles of corporate governance. Two of the 23 were *largely observed*, 18 were *partially observed*, and three were *materially not observed*. Since that World Bank report was published, awareness of the problem has increased and Indonesia has made advances in corporate governance.

There is vocal demand for modernized Company Law, streamlined systems for company startup, registration, and licensing, and improved corporate governance. Efforts are underway to address each of these demands.

Recommendations

- Establish a process for continuous review, revision, and updating of the new company law. This can be done through the new Company Law Monitoring Experts body and other relevant organizations.
- Continue to broaden the new Company Law consultation process. Solicit input from select prospective users, including lawyers, businesspeople (including entrepreneurs, company directors, and commissioners), other professionals (including accounting firms, judges, notaries, corporate governance organizations, BAPEPAM, and the stock exchanges), and relevant ministries. Consider the suggestions presented in the annex that follows this recommendations section.
- Further reform the company registration process. Create a new company registry if necessary. Through reforms:
  - Make registration quicker—it should take at most a few days.
  - Reduce the cost of registration, and publicly post fees.
  - Reduce subjectivity in the registration process—there should be no government discretion in the process. The government should only check for ministerial errors in the filings.
  - Provide standard printed forms that a small business can use without a lawyer or notary.
  - Minimize or eliminate notarial requirements.

[29] Interviewees provided the following anecdotal information. There is no official public information. Women-owned businesses are "by far most unregistered small businesses." The number of employees or the assets of businesses that might register and seek licensing under a reformed system is "very substantial." Recent improvements in company registration have encouraged "very little" small business registration, "if any."

  - Eliminate the *Gazette* publication requirement.
  - Make it easy to register (create) a new company with limited liability without regard to whether the company needs licenses and permits for later specific activities.
  - Maintain basic information about companies and make it available to the public for free.
  - Establish and maintain an attractive website that clearly displays governing laws, procedures, fees, forms, and company data.
- Coordinate and streamline the process for obtaining business and sectoral licenses and permits, especially for startup businesses. In this connection, consider:
  - Establishing the Investment Coordinating Board as a true "one-stop shop" regulator with real power to coordinate and make substantive decisions.
  - Expanding the work already initiated by the Asia Foundation.
- Take more steps to strengthen monitoring and enforcing good corporate governance. In this connection, consider:
  - Updating and establishing a procedure for continually revising the BAPEPAM rules so that they are consistent with the Code of Good Corporate Governance and other best practices. Consider requiring all public companies to publicly explain any noncompliance with the new Code of Good Corporate Governance.
  - Clarifying and specifying the enforcement powers of BAPEPAM and the stock exchanges, including the power to levy fines, issue cease and desist orders, suspend trading in a particular stock, delist a particular company, bring litigation in court, and publicly expose defaulting companies through public announcements or press releases. This clarification could be accomplished through additional BAPEPAM rules or an amendment of the Capital Market Law.
- Increase attention to corporate governance in: (1) closely-held, small, and family companies, which, though they are the bulk of Indonesian companies, are not subject to BAPEPAM or stock exchange regulation; and (2) state-owned companies, which are not governed by the Company Law. Regarding closely-held companies, the Company Law could be revised and strengthened as suggested in the annex that follows this recommendations section. Also consider expanding the Code of Good Corporate Governance to include specific provisions for private and family companies. Regarding state companies, the code could be revised to incorporate or adapt provisions of the OECD Principles of Corporate Governance for State Owned Enterprises.
- Analyze the actual rates and specific drivers of informality. Study especially the phenomenon of larger businesses that choose to remain informal. Base reforms on a more nuanced understanding of the drivers of informality.

Annex: Specific Suggested Revisions of the New Company Law

The following suggestions are respectfully made for considerations and discussion.

General Points

- Overall drafting and organization. To make the law more useful and user-friendly, begin with a table of contents listing all articles; give each article a subject heading stating its contents; and place each subject in the same place when possible (e.g., the shareholder vs. director or commissioner lawsuit standards now in Articles 61, 95 and 111-12[30]).
- Allow one-owner companies.
- Eliminate the concept of legal capital from the law, together with associated concepts such as "nominal value of a share." Many other countries have done this in recognition that those concepts are unclear, complex, and confusing (and subject to manipulation) as an accounting matter, and do not serve to protect either creditors or shareholders as a practical matter; they are also not enforceable. The initial capital requirement also stands as a barrier to registration of small entrepreneurial companies.
- Regarding company registration, embody the second "Recommendation" above in the law itself. This would require revising Articles 7-18. Also state clearly that a company can begin its existence (and with limited liability) before it obtains all necessary sectoral permits or pays later-assessed fees. This is important for getting a company started and organized pending the long delays in receiving those permits.
- To improve financial reporting and transparency, require that all companies of the types stated in Article 68 must have annual independently-audited financial statements prepared in accordance with international accounting standards.
- Clarify and simplify the rules for amendment of the Articles of Association (Articles 19-28). For example: do not require Minister approval or a notarial deed for amendments that the shareholders have properly approved (21); and provide that such an approved amendment is effective at the moment of its filing in the public registry.
- State in more detail the rules for stock. For example, state that every company must have common stock and that all common stock has the same rights, which include one vote per share; this promotes transparency and investor control (and would require a change to Article 82). State that any company may also have one or more classes of preferred stock with preference over common stock for dividends and/or liquidation distributions, but *all* of the rights and preferences of each class of preferred stock must be fully stated in the company's publicly-filed Articles of Association. Further, state that preferred stock does not have voting rights (except possibly in exceptional cases where preferential dividends are in default or the preferred is convertible into common stock). State explicitly that bearer shares are prohibited. As a further point, the limitations on share transfer in Articles 57-60 should not be permitted in public companies. Expand the dissent and "putback" provisions in Article 62 to add detailed procedural and appraisal rules as in other countries' laws. Make it clear in the new law that a company may issue securities other than shares, including bonds, convertible instruments, options or warrants to acquire shares, and Islamic securities.

[30] See footnote 2 above regarding article numbers.

- Add detail to the rules for convening, conducting, and voting at shareholder meetings. Include more rules for advance notice to shareholders, setting the record date, setting the agenda (including allowing shareholders to propose agenda items including director nominations), proxies, more detailed quorum requirements, rights to secret ballots in director elections and other cases, vote counting safeguards, minority calling of shareholder meetings and other matters. International experience has shown that these seemingly minor details can be essential to protect the integrity of shareholder control and to forestall argument and dispute. State that ordinary matters are to be decided by majority vote of shareholders (not 50 percent as now in Article 85 (at least in the English translation)), and clarify and add to the current list of major decisions the items that may require a two-thirds vote. Consider adding a "more than 50 percent" asset sale to the items that require a supermajority vote under Article 87 (since that is now included in the items in Articles 62 and 100) and consider reducing the three-quarters vote requirement in Article 87 to two-thirds; international experience has shown that it is often impossible for companies to muster a vote as high as three-quarters on any issue.
- Clarify the roles and responsibilities of a company's boards of directors and commissioners. For example, provide that all directors and commissioners are to be elected or re-elected at each annual shareholder meeting (although there should be no limit on how many times one can be reelected); that their *individual* compensation and benefits must be approved by the shareholders See Articles 94 and 110); that cumulative voting may be adopted so that minority investors can elect directors in proportion to their minority holding; that a public company must have some independent directors (sometimes defined as directors who for two years were not employees of and did not have specified types of dealings with the company, and who do not own more than 30 percent of the company's stock); and the board of a public company must have an audit committee that includes or consists exclusively of independent directors, a nominating committee, and a compensation committee with duties spelled out in the law. Consider more detailed rules for convening, conducting, and voting at directors' and commissioners' meetings and allowing "virtual" electronic meetings and actions by consent with no meeting at all.
- Add new rules to give a company more freedom and flexibility in declaring dividends and buying back its own stock, and add more realistic restrictions to protect creditors. Such restrictions should include a prohibition on dividends or buybacks that would render a company insolvent on a balance sheet test or unable to service its debt in the ordinary course of business. The formalistic restrictions now in Articles 70-72 (based on reserves, "profit balance," and paid-up capital) do not reflect actual business practicalities or protections as seen by creditors. Both dividends and buybacks should be subject to the same restrictions. Also, expand Article 72 to state that the directors who cause a company to pay prohibited dividends, and shareholders who accept them knowing they are prohibited, are personally liable to return the amounts illegally paid or received.

Fiduciary Duties and Liabilities of Directors and Other Controlling Persons

- The BAPEPAM rules and the Code of Good Corporate Governance cover this subject, but it should also be covered definitively in the company law because the company law – unlike the rules and the Code – is both (1) mandatory and (2) applicable to all companies, public or private. It is suggested that the provisions in the draft company law (see Articles

61, 95 and 111-12) be consolidated and expanded to incorporate internationally-recognized definitions of the duties of care, good faith, and loyalty that directors, commissioners, and company officers should have to the company, and to extend some duties to controlling shareholders of the company. The law should have specific definitions of the concept of "personal interest" (to cover family relationships, for example), and rules for authorization of any contracts or transactions between a company and a covered person by "disinterested" directors, shareholders, or others who have no personal interest in the matter. These (including rules for approval of conflict transactions) should be consistent with the rules now in the Capital Market Law, the BAPEPAM rules, and the Code of Good Corporate Governance. The law should also set more detailed rules for lawsuits against directors, commissioners, and other persons in control of a company, even if such lawsuits are yet unknown in Indonesia. In other countries such rules have served to facilitate such lawsuits but also to protect directors against harassment and possible attempted extortion by use of frivolous lawsuits.

Private and Smaller Companies

- The majority of Indonesian companies are in this category, and the law should have simpler and more flexible provisions for them, as opposed to public companies that can have an unlimited number of shareholders, including passive investors who need more formal protections as are required in a PT. The company law should be easily usable by the smallest businesses with no need for a lawyer, or by large closely-held businesses, including international joint ventures whose owners can custom-negotiate a shareholder agreement among themselves. To serve this need (and to conform to private company laws in many other countries[31]), the following is suggested:

    - Make clear that a private company's members, unlike in a PT, may structure its governance as they wish (e.g., the private company could give all members equal management authority, or it could name certain persons as managers, or it could have a formal elected body like a PT's Board of Directors or Commissioners and formal shareholder meetings as in the present company law). However, there should also be a "default" provision that specifies the structure if the members do not agree otherwise (for example, it could state that they have equal authority as in a partnership).
    - Allow a private company's members, unlike in a PT, to share votes and share profits and other distributions as they wish (e.g., equally, on a family basis, in proportion to their capital contributions, or on some other agreed-upon basis). Arms-length joint ventures might have several classes of ownership units with different votes, different rights to appoint a particular manager or board member, etc. However, the law should state how such things are shared if the members do

[31] In many countries this is done with a separate form of company (e.g. a limited liability company as in the US, Continental Europe and Gulf countries); in some it is done with special rules for private companies within the same company form (e.g., for private as opposed to public limited companies (PLCs) in the UK). It can also be done within partnership law by (e.g.) allowing a general partnership to have partners which have limited liability.

not agree otherwise (for example, it could state that they share equally in that case).

- Allow a private company, by agreement of the members, to impose whatever restrictions on sale of shares they wish (e.g., free transferability (no restrictions), transferability only to family members or other company members, requirement of a first offer to the company or to existing members). However, the law should state how transfer is restricted if the members do not agree otherwise (for example, it could restrict transfer to inheritance or transfer with unanimous or "X%" shareholder approval)
- Provide that decisions in a private company are made by majority voting power except that certain very major decisions require unanimous consent, such as admitting a new member, amending the charter, sale of the company's assets, merger with another company, etc. However, the law should also allow the members to vary even those requirements.

In any event, the law's private company provisions for fiduciary duties of controlling persons and for shareholder access to financial and other company records should be essentially the same as for public companies. Such provisions should also extend to partnerships and CVs that are created under the Indonesian Civil Code.

CONTRACT LAW AND ENFORCEMENT

Introduction

The ability to make and enforce contracts under a clear, consistent legal framework is crucial for economic growth. When businesses and individuals feel certain that agreements will be promptly and efficiently enforced, risk diminishes, the cost of doing business is reduced, and long-term planning becomes possible. Indonesia's contract law is comparable to the contract law established in other major commercial countries. It allows businesses to enter into agreements freely and seek justice from a court or other tribunal when necessary. However, contract enforcement in Indonesia can be so uncertain, unpredictable, and costly that the adequacy of the law itself has become meaningless. The poorly developed Indonesian court system is the cause of these enforcement problems.

Legal Framework

General. The basics of Indonesian contract law are stated in the Civil Code (Articles 1233 and on) and the Commercial Code, which were derived from the corresponding Dutch codes that were in effect at independence in 1945. Like Dutch law then and now, the Indonesian codes resemble the codes of continental European civil law countries.

Running in parallel but separate from these Western codes are additional legal traditions that include other contract law elements: native Indonesian customary law (*adat*), Islamic *sharia* law, and, to a certain extent, the legal traditions of foreign Asians who have long lived in present-day Indonesia. Those other traditions still thrive on a regional basis but are not part of the general structure of modern Indonesian business law.

Indonesian contract law is extraordinarily detailed and specific on many points, yet often exhibits a "one size fits all" approach. For example, the code states that:

- A debtor who does not fulfill his agreement is liable for costs, damages, and interest (1239).
- The compensation that a creditor is entitled to recover consists of the loss he suffers and the lack of profit he was supposed to enjoy (1246).
- The validity of an agreement needs four qualifications: consent of the parties, capability to make an agreement, a particular object, and a lawful cause (1320).
- Any ambiguities in a contract must be interpreted according to local custom at the place where the agreement was made (1346).
- If there is doubt as to meaning, an agreement must be interpreted to the damage of the person who requested it and the benefit of the person who has bound himself at the other's request (1349).
- An agreement is extinguished by any of 10 specific listed events – whether additional events are permissible grounds for extinguishing an agreement is unclear (1381).

- If property that is the subject of an agreement disappears, then the agreement itself is eliminated (1444).
- If a purchase has been made with advances, a party cannot cancel the purchase by returning the advances (1464).
- Property that is sold must be delivered in the same condition it was in at the time of the contract to sell (1481).
- If the price in a sale of immovable property is set by mentioning its width or contents but the property is in fact larger than mentioned, then the buyer may add to the price proportionately, or may cancel the purchase if the excess is more than 1/20 of the width mentioned in the contract (1485).
- The right to repurchase sold goods may not be agreed upon for a period of longer than five years and, if it is, the period must be reduced to five years and a judge is not allowed to increase it (1529–1530).

A common-law lawyer might worry that this degree of specificity might inhibit business transactions by not allowing for understandings unique to a particular deal or the flexibility required to deal with constantly changing and evolving business practices and marketplace expectations. Indonesian lawyers who were consulted on this matter said "not to worry" and pointed to three more general articles—1233, 1338, and 1239—that are viewed as overriding the more specific articles:

- "Every agreement is established by consent or by the law" (1233).
- "All agreements that are made legally shall apply as the law between the parties who made them" (1338).
- "An agreement is not only binding as to the matters explicitly stated therein, but also as to everything that according to the nature of the agreement, obligated by courteousness, customary or law" (1239).

These provisions, combined with actual practice and business convention in Indonesia, reportedly have established a "freedom of contract" rule that allows parties to make any kind of contract they wish unless it is contrary to public policy. Interviewees also pointed out that the code has several "common sense" provisions; for example, a debtor is only liable for damages that could have been expected when the agreement was entered into (1247); a debtor is not liable when performance is prevented by *force majeure* (1245); and if the wording of a contract is open to various interpretations, one must investigate the intention of both parties rather than hold to the literal sense of the words.[32]

[32] Obviously, people doing business in Indonesia must retain good local counsel who can ensure that obscure provisions of the Civil Code cannot be used later by another party to a contract to frustrate their clients' business operations.

Formalities. Ordinary business contracts are not required to be in written form and do not require notarization or state registration for their validity or enforcement. Indonesian lawyers confirmed that the Civil Code, notwithstanding all its other detail, makes no such formal requirements.

There are exceptions for specific types of documents, such as the requirement that a company's Articles of Association and ongoing shareholder resolutions must be in the form of a written notarial deed, but that rule does not apply to normal commercial agreements among businesses and businesspeople.

Remedies. The Civil Code refers throughout to breach-of-contract remedies of types that are familiar in other countries, including:

- *Damages*, such as out-of-pocket damage, costs, interest, consequential loss of profit, rescission, and declaration of a contract's "nullity." See articles cited above and Article 1242, which refers generally to damages for breach of contracts other than contracts "to do a specific thing."
- *Self-help and court orders for specific performance*. See Article 1241, which states that "the creditor can be authorized to execute the agreement himself at the debtor's cost," and Article 1267, which states that "the party on whom the contract is not fulfilled has the option either, if it is still possible to be done, to force the other party to fulfill his agreement, or to claim termination of the contract with compensation of costs, damages and interest."

Theoretically, these remedies can be requested in an Indonesian breach of contract lawsuit. However, it is unclear whether the court would be familiar with the relevant provisions and would recognize precedent from other courts. A further question is whether, if the court issued a judgment ordering damages or specific performance, the judgment could be enforced as a practical matter.

Enforcement. In practice, the contract law problem in Indonesia is not the written law but the absence of an independent, effective, and precedent-respecting system of enforcement.

This subject is covered in detail in this report's chapter on Commercial Dispute Resolution and therefore that discussion is not repeated here. However, respondents made the following specific points concerning contract disputes:

- In much of the Indonesian economy, contracts exist between parties with unequal bargaining power, sophistication, or access to lawyers, which makes it all the more important to have an effective court and enforcement system.
- Contracts exist between farmers, their trader/middlemen, and their buyers. Many of these contracts are verbal because the parties wish to avoid the hassle of negotiating written contracts. However, many of these contracts are very detailed and worth great sums of money. It is not uncommon for some parties to a contract to walk away from the contract when they find a better price elsewhere, and they are able to get away with this behavior because there is no system of enforcement. Many of the jilted parties are unaware that courts are available for disputes.

- The result is a closed, too-local market that is based on personal reputation and trust rather than on freely negotiated arms-length contracts. This greatly reduces market opportunities.

Implementing Institutions

Courts. The courts are the ultimate legal recourse for resolution of contract disputes. Interviewees questioned about the use of contracts agreed that courts are "avoided whenever possible" because they are slow to decide, costly and cumbersome, sometimes hard to locate physically, uneducated in company and business matters, and simply not very useful. Most respondents also complained of corruption in the court system. One person noted that special payments, rather than court costs, make litigation too expensive for potential litigants to consider as a viable option.

Other dispute resolution bodies. Arbitration and mediation are not often used as alternatives to the courts. The unavailability (or non-use) of local independent dispute resolution mechanisms is a major negative for business dispute resolution in Indonesia – it is unfortunate that an option that would increase the rate at which disputes can be resolved is not considered viable or useful to the relevant parties. Arbitration clauses are often negotiated in major business contracts (particularly in international transactions), but respondents stated that these almost always specify a governing law other than Indonesian law (English law is commonly used) and an arbitration body and venue outside Indonesia (Singapore and London are popular). Indonesia is a party to the New York Convention, which means that foreign arbitral awards are theoretically enforceable in Indonesia. However, local execution on a foreign judgment can be difficult.

Supporting Institutions

Lawyers and other professionals. We interviewed several private lawyers, law firms, and accounting firms in Jakarta. The advice of these professionals can help in situations where problems with enforcement are anticipated. Due to funding and organizational issues, the major Indonesian bar association, the **Indonesian Advocates Association**, it is not currently as active as it could be or as bar associations are in many other countries.

Legal education. The law school curriculum in Indonesia includes components on domestic contract law, the Civil Code, and international conventions and practices. In the Faculty of Law at the University of Indonesia, there are courses on subjects such as international contract law, international conventions, and contract drafting. Some law school professors have published academic treatises or interpretations of the Civil Code to guide courts and lawyers.

Social Dynamics

As indicated above, written and oral contracts are common in virtually all business sectors. Lawyers are experienced in writing them, businesspersons are experienced in negotiating them, and there are no cumbersome formalities or artificial impediments to discourage their free use. This is true even in agriculture at the farmer-producer level. Interviewees noted that larger businesses that retain more experienced (and expensive) lawyers have an advantage in contract negotiation.

However, due to the lack on an independent dispute resolution system, contracts in Indonesia tend to be "guides" or "living documents" subject to constant renegotiation rather than strict documents that are expected to be observed literally. This characterization was given by many respondents, including lawyers who litigate and draft contracts, businesspersons, and NGO and donor representatives who work with small and medium-size businesses. Parties with enough leverage can simply walk away from contracts, or can force renegotiations with the help of the market.

One notable result of this state of affairs is that trust and personal reputation play a larger role in selecting business partners than in countries where contract law and enforcement are clearer and stricter. The system also discourages investment and limits business opportunities.

Recommendations

- In the long term, revise the Civil Code to reflect current and changing business conditions. Particularly, the "general and overriding" provisions should be clarified and more provisions should be added to make it clear to lawyers and investors that the law is open and flexible, and that its overly-specific provisions cannot be used override or frustrate pro-business intentions.

REAL PROPERTY

Introduction

An efficient and fair system governing the registration, use, mortgage, and sale of real property is a critical enabler of economic growth. It allows individuals, farmers, and enterprises to invest in activities that concern land. It eases the burdens of ownership, use, collateralization, and sale of land and buildings. Good property law is particularly critical in transition-economy countries because it enables entrepreneurs of all stripes to freely acquire land in order to produce food, goods, and services in an environment that guarantees secure ownership and allows for long-term planning. It also accommodates economically beneficial changes in land use, such as the replacement of a dormant factory with a new one, within environmentally sensitive guidelines. A good property law must also be accompanied by an objective, standardized titling system.

The serious deficiencies of Indonesia's real property system particularly affect the poor and middle class. The complicated and myriad overlays of state intervention and government agency involvement compound the problems that they are meant to solve. As a result, foreign and domestic investment suffers, and many poor Indonesians cannot actualize or exploit their customary property rights.

Legal Framework

"The land, the waters and the natural riches contained therein shall be controlled by the State and exploited to the greatest benefit of the people."

Constitution of Indonesia, Chapter XIV, Article 33, Para. 3

Indonesia's land law and practice have been shaped by the indigenous customary law (*adat*) and by legal changes applied during the colonial period. Dutch rule concentrated control in central authorities, as exemplified by the ***domein*** concept. Under this concept, "the State owns all land that the State has not titled in the name of a private person or legal entity."[33] The *domein verklaring* (Law No. 118 of 1870, Article 1) stated that all lands without evidence of individual or communal ownership were state land. *Domein verklaring*, however, recognized village lands or land that was cultivated by people although there was no written evidence of title. The implication of this policy was that all lands were under the control of the sovereign, who had broad discretion in permitting and enabling the sale and transfer of property. Application of colonial Dutch agrarian law favored the development of large capital interests.

After independence, the Indonesian government began making fundamental changes to its commercial law framework. It promulgated the Basic Agrarian Law No. 5 of 1960 (the UUPA). This law serves as the primary law pertaining to both agricultural and residential land. It unified the Dutch and customary land title systems by phasing out the land laws issued by colonial authorities. It was heralded as a breakthrough in reorienting Indonesia's land regime toward supporting community welfare and justice. Other stated objectives of the law were to achieve unity and simplicity in land law and to create a basis for legal certainty concerning law and land rights.

[33] Rural Development Institute (RDI), *The RDI Report*, 2006. p.16.

The UUPA abolished the *domein* concept by setting forth the proposition that land is a gift of God to the Indonesian people. Land ownership has a social function, meaning that owners acquire both rights and obligations attendant with land ownership. Moreover, the state, as an entity of the people, has been delegated the authority to govern and control all land. In practice, however, the UUPA did not abolish *domein* as a social institution.[34]

As the first step in what was intended to be a series of laws and actions to be promulgated concerning land rights and property system, the UUPA left some things undone. In 1961, Indonesia embarked on its first land reform initiative based on Law No. 56 PRP of 1960 regarding the Limitation on Maximum Farmland Ownership, but that initiative came to a halt following a Communist uprising.

The UUPA is buttressed by several other pieces of legislation, notably Law No. 5 of 1967 (the Basic Forestry Law, as amended by Law No.41 of 1999) and by Law No. 11 of 1967 concerning mining. A better term may be "trumped", as the effects of those laws have been to supplant the UUPA in those parts of Indonesia classified as either forest or mining areas, amounting to well over half of the land area of Indonesia.

The stated intent of these laws is to synchronize the various claims and national interests of Indonesia's numerous tribal and cultural backgrounds and customary approaches to agricultural resources. In practice, however, traditional laws have often been ignored.

The following kinds of ownership rights are titles obtained through a formal registration process:

- Right of ownership (*hak milik*): The strongest and most complete right, from which the other rights are derived. It may be claimed by Indonesian natural persons and certain legal entities, such as government banks, religious groups, and social bodies. It does not include mineral rights beneath the soil. This type of ownership may be mortgaged (*hak tanggungan*).
- Right to use (*hak pikai)*: The right to commercialize and develop land owned by the state for a particular period (UUPA Articles 28–34, as regulated by Governmental Regulation No. 40/1996). The new Capital Investment Law provides for up to 70 years (Law No. 25 of 2007, issued April 26, 2007).
- Right to exploitation (*hak guna usaha*): The right to agricultural exploitation and harvest (akin to *usufruct*) of parcels derived from state government land greater than five hectares

[34] The RDI report states the following: "Because the UUPA was drafted by populists, it is presumed—against overwhelming evidence to the contrary—to provide real protection to the interests of common people. In fact, the approach taken in the law, which was to empower the State to define and protect the interests of the people, has been subverted for the past four decades by Government administrations which defined the national interests in ways that did not benefit large segments of the populations, and that forced some segments of the population to relinquish their land, causing them to bear a disproportionate share of the costs of the nation's economic development. The law is filled with vague statements to the effect that Indonesian land must be used to advance the interests of the people. But the law contains no substantial limitations upon Government power to use land claimed by citizens in ways that those citizens find objectionable. The Government remains relatively unconstrained in its ability to appropriate land and allocate it to serve interests of private and State corporations." RDI report at 25.

(12.4 acres). This ownership right is transferable, and may be mortgaged. According to the new Capital Investment Law, foreign investors may own such land for up to 95 years.

- Right to build (*hak guna bangunan*): The right to build and use buildings for a period of 30 years, renewable for up to 80 years pursuant to Government Regulation 40 of 1996. This ownership right is transferable and may be mortgaged. The new Capital Investment Law provides the right to build and use buildings for up to 80 years initially without the need to renew.
- Strata rights: Condominiums are built on land using certificates good for 25 years with 20-year extensions.

Property ownership. Most property in Indonesia is held in the informal system through customary forms of title or communal ownership interest.

Land in the informal system is sometimes referred to as "individual land" or "customary land." Only about 30 percent of parcels (about 35 million parcels) have been titled according to the requirements of the UUPA and brought into the formal State Land system. Measures are underway to systematically title more areas, but this long-term task is not progressing at a meaningful pace.

Formal System. Under the State Land system, the UUPA sets forth a number of rights relating to the use and ownership of land, subdividing the Western concept of "fee simple" ownership into a package of different rights that can be held or transferred independently. Leasing rights (***hak sewa***) and sharecropping rights (***hak usaha bagi hasil***) do not require registration with state authorities.

In accordance with the Constitution's provision that land is for the social benefit of the people, there are some significant restrictions on real property ownership. Indonesian citizens and Indonesian legal entities may exercise many rights, with one exception being restrictions on agricultural use of land based on population density and soil type (Law No. 56 of 1960 regarding the Limitation on Maximum Farmland Ownership.) Furthermore, Indonesian citizens may also possess ownerships rights in forest land as provided in Law No. 41 of 1999.

Foreign individuals and entities may not own land or agricultural resources directly,[35] with the exception that they may own residential condominiums. Until recently, foreigners could only lease real property for a maximum term of 25 years; however, the new Capital Investment Law (Law No. 25 of 2007) provides improved guarantees of land tenure, including the right for foreigners to build for 80 years and the right to use for 70 years. Prime farmland is not available to foreign investors.

[35] Article 42 of the UUPA bars foreign citizens from owning land outright, although foreign individuals may own up to 100 percent of foreign-owned companies incorporated in Indonesia. The UUPA permits foreign citizens and foreign legal entities the right of use (Article 42) and right of land lease (Article 45, UUPA, and Law No. 4 of 1992).

Sale and Transfer. Transfers of real property rights are formalized through a title deed. A title deed is accompanied by a survey that identifies the location and dimensions of the land. Deeds are drafted by a Land Deed Official, known as a "PPAT." PPATs are typically notaries and are readily found throughout Indonesia.

When rights are transferred to foreign persons, the rights must be downgraded to a right to build, right to exploit, or right to use. To rent, sell, contribute, inherit, and exchange any rights in land, the owner does not need any permission from the government. The initial right to use the building or apartment, however, does first require a permit. Rights may be transferred by inheritance (either by testamentary disposition or through operation of law) or through sale or gift by use of a Grant Statement Deed.

Under the new Capital Investment Law, renewals for foreigners have three requirements: the land must be in the possession of the applicant seeking the renewal, the land must be used for public interest, and the use title must be in line with city planning.

Transactions or transfers of rights over land require signatures of the interested parties and notarized deeds. If land has not yet been registered, the transfer may be done with the assistance of a notary and may be registered at that time. Transfer by inheritance does not require signatures of the parties.

The several taxes paid upon sales of land can cumulatively levy an effective 20 percent governmental tax on transfers. In most areas of Indonesia, including Jakarta, there is a general five percent transfer tax on the seller, a 10 percent value added tax, and another five percent tax on the buyer.

In Indonesian law, there is no uniform tax rate for transfers of land. This is regulated by Law No. 21 of 1997 as amended by Law No. 20 of 2000. Transfers of land valued at 60 million rupiah or less are not taxed, but sellers are taxed if the price is higher than 60 million rupiah. The tax for a *seller* in this category is five percent of the price of the land (a rate applied nationally), but the tax for the *buyer* depends on the location of the land. In Jakarta, the buyer will be taxed the price of the land, minus 60 million rupiah, times five percent. The seller will be taxed only if the price of the land is more than 60 million rupiah, and will be taxed at five percent of the price of the land. In Depok, West Java province, buyers will pay a tax equal to the price of the land, minus 60 million rupiah, minus 20 percent, times five percent.

This high tax burden has led to various practices to avoid these payments, including common use of contracts that significantly understate the sales price.

For inheritance, title is protected by law, with or without delays in registration. Transfers of rights by inheritance are taxed at approximately 2.5 percent of the value of the property. Again, there is no uniform tax for transfer of rights by inheritance; tax depends on the location of the land. In Depok, West Java, the rate is calculated as the Tax Object Sale Value (NJOP), minus 100 million rupiah, times five percent, times 50 percent. Costs for transfers of land ownership vary from region to region. Likewise, costs charged by notaries can vary. Based on Law No. 30 of 2004 regarding notaries, notary fees depend on the economic and social value of the transaction. On the economic scale, the maximum notary fee for transactions valued up to 100

million rupiah is 2.5 percent. For transactions valued between 100 million and 1 billion rupiah, the maximum notary fee is 1.5 percent. For transactions valued at more than 1 billion rupiah, the maximum notary fee is one percent. The social value is based on the social function of the object of a deed, with a maximum honorarium of five million rupiah permitted for the notary (Law No. 30 of 2004, Article 36). For lower-end transactions, the costs can become prohibitive, and real property respondents complained that the high costs are such a problem in real estate transactions that many low-end transactions are simply not registered in order to avoid costs and taxes.

Indonesian law does not require any minimum lease for agricultural land, but does stipulate that lease payments be made either in a lump sum or over time. In practice, this means that the parties to the transaction can set the price and terms of payment.

Eminent domain. During this diagnostic, there was some public controversy over the exercise of eminent domain. A leading public figure was impatient over difficulties in acquiring properties for much-needed infrastructure projects, including new roads. The public's more vocal assertion of rights may have something to do with the frustration.

Law No. 20 of 1960 provides that the state may revoke rights for a "public purpose," such as the building of roads. The meaning of "public purpose" was originally not well defined or clearly limited, giving rise to some insecurity regarding whether the state may define the term based on political considerations not anticipated by a developer. More recently, the government issued Presidential Regulation No. 36 of 2006 regarding Land Acquisition for Development for Public Interest, as amended by Presidential Regulation No. 65 of 2006. Article 5 paragraph (a) determines that the "public purpose" includes: (1) public roads and toll roads, railways (on the ground, in the space above the ground, or underground), drinking water/clean water systems, drainage and sewage systems; (2) reservoirs, dams, irrigation channels, and other irrigation buildings; (3) ports, airports, railway stations, and terminals; (4) public safety facilities such as levees to protect from floods, lava, and other disasters; (5) waste disposal; (6) natural reserves and cultural reserves; and (7) electricity generators, transmitters, and distributors. In the event of acquisition for public purposes, the government is required to pay adequate compensation.

Based on this regulation, compensation is determined through amicable negotiation. Article 1 paragraph 11 states that compensation shall make the life of recipients better than before the land was acquired. Article 13 states that compensation can take the form of money, and/or substitute land, and/or resettlement, and/or some other arrangement as agreed to by both parties. If the parties cannot agree about compensation, the land acquisition committee will determine the form and amount of compensation and consign the compensation money to the relevant District Court.

Mortgage. Mortgage is governed by Law No. 4 of 1996; this law applies only to land that has already been registered, without regard to land designation or use. Article 11(2) of the law permits the parties to define the various rights of each in mortgage transactions. Notaries play a prominent role in such transactions. There is an active mortgage market in Indonesia's big cities. Banks rely not only on registered titles, but also accept certificates as proof of ownership. Since land may only be owned by natural persons, corporations must avail themselves of use rights. Mortgages may be foreclosed judicially.

Law No. 4 of 1996 gives mortgagees (creditors) the right to sell foreclosed property through a public auction without resorting to the courts. The certificate of *hak tanggungan* serves as a court order.

Formalizing the customary system. Article 5 of UUPA provides that the agrarian law prevailing in Indonesia is traditional or customary law, so that traditional law applies to unregistered lands. Most owners of such land hold Customary Right of Ownership (*hak milik adat*). Pursuant to the UUPA, such titles are convertible to freehold titles (right of ownership or *hak milik*). Other titles that are convertible to freehold titles are the *verponding* issued by the Dutch colonial government, and the *girik* issued by the Indonesian government before 1960. However, a *girik* is only considered strong evidence of ownership when registering.[36]

A title can be revoked if another party is able to prove his right to the land. If no claims are made within five years of initial registration, the government will issue an irrevocable ownership certificate. There is an alleged 20-year standard for adverse possession, where a person openly using land in good faith is deemed to be the owner. Based on Government Regulation Number 24 of 1997 regarding Land Registration, Article 24, this adverse possession only applies to state land. It does not apply to individual or indigenous property rights because adverse possession is not permitted under Law No. 51 of 1960 regarding Prohibition for Use of Land without Permission from Rightful Owner.

Registering land is costly and it does not result in immediate or clear benefits. The process involves many steps. First, the owner must obtain a stipulation from the Forestry Ministry that the land being registered is not State Land. A fee of five percent of the value of the property is assessed for this document. Then the owner must survey the property, pay a five percent tax, and typically use a PPAT notary to file and register the title. In law, based on Government Regulation No. 10 of 1961 as amended by Government Regulation No. 24 of 1997, the requirements for registering land for which one has *girik* are:

- A letter from the village head that states that there is no conflict of ownership on that land
- A letter regarding the history of the land from the village head
- Evidence of transferred rights of that land since 1960
- *Girik* or proof of land tax payment
- Proof of Land and Building Tax payment up to the present year
- Survey and measurement by a National Land Agency officer
- Announcement in the National Land Agency Office for two months.

If there is no objection from other parties, the National Land Agency will issue the certificate of ownership. There is no uniform cost for acquiring letters from the village head. The cost can range from one to 10 million rupiah, depending on the size and price of the land.

[36] *See* Government Regulation #24 of 1994.

There is no legally prescribed requirement that a person use a notary or a land conveyor to register land. Owners or other persons on their behalf can register land directly with the National Land Agency Office closest to the land.

Land use and zoning. Law No. 26 of 2007 regulates zoning through various principles, including harmony, integrity of resource use, sustainability, effectiveness and efficiency, transparency, protection of public interest, certainty and justice, and other standards subject to discretionary interpretation. The loosely defined system allows for a great deal of abuse and rent-seeking behavior. The law defines certain limitations on "monopoly" or centralized control of land. Consequently, developers may not use a master building concession or master right to use, but must instead be subject to agreements that, upon construction of the building, will be transferred to a third party.

Zoning implementation is divided among national, provincial, and district government/city levels (Law No. 26 of 2007, Article 5). Spatial layouts prepared for the national level are then elaborated and adjusted to provincial or district conditions and vice versa. Law No. 32 of 2004 aims to further decentralize zoning so that it becomes the responsibility of each district. In practice, zoning is changed in accordance with developer needs and interests. Frequently changes occur because of corruption, collusion, and nepotism rather than legitimate needs for rezoning. People who are unable to develop their land in accordance with local spatial development plans often sell their land to people who can develop it.

Law No. 26 of 2007 establishes incentives and disincentives for acting in accordance with the law. In Article 38, incentives include: reduced tax, cross-subsidies, compensation, joint shares, infrastructure development, speedy permit procedures, and rewards. Disincentives include: paying higher taxes, limitations on access to infrastructure and compensation, and finality. Violations by individuals or government officials are punishable under penal law (Law No. 26 of 2007, Articles 69–74). People who suffer losses due to violations of the law can sue for compensation based on civil procedure (Law No. 26 of 2007, Article 75).

Law No. 20 of 1991 allows the state to reclaim land without compensation for violation of zoning plans. Government Regulation No. 36 of 1998 stipulates that abandoned land shall become the state's land; a significant amount of land has returned to state control since the 1997 economic crisis. However, the law also provides that the former owners are eligible to receive compensation.

Taxation. Property taxes are intended to provide revenues at the central, provincial, district, and municipal levels. Property tax collection is conducted at the local village or district level, while taxes related to transfers of land are paid to banks appointed for that purpose. Property taxes are not based on market price, but rather on constructive values (NJOPs). NJOPs are determined by the classification of the roads in the region where the land is situated and by the size of the land and buildings involved. In principle, this regime provides protection to poorer Indonesians. In practice, this protection is limited.

The assessment team interviewed middle class people who pay municipal real property taxes in the Jakarta region. These taxes are low by Western standards, reportedly amounting to less than 0.1 percent per annum of market valuation. Nonetheless, increasing land values coupled with

high real estate taxes have become a strain for many poor people, compelling them to sell their property in order to pay their taxes.

Implementing Institutions

As summarized in the table below, while the time to complete a land transaction may be match the standard set by OECD nations, other challenges remain.

Indicator	Indonesia	Region	OECD
Procedures (number)	7	4.2	4.7
Time (days)	42	85.8	31.8
Cost (percent of property value)	10.5	4.0	4.3

Source: World Bank, *Doing Business 2007*

Multiple agencies implement real property law. The World Bank Doing Business unit has estimated that up to seven different agencies may become involved in real property transactions. This discussion will focus on two of the primary implementing agencies: the National Land Agency and PPATs.

The **National Land Agency (BPN)** is the administrative unit of the **Ministry of Interior.** BPN maintains a national headquarters and provincial offices throughout the archipelago and employs several thousand people. The diagnostic team received only one response from BPN for a visit, and that was not to a registry office but rather to a director's office at national headquarters. Thus, the information about BPN in this report has not been substantiated by personal inspection.

BPN is tasked with the enormous challenge of maintaining existing land registries while also encouraging the registration (or formalization) of customary landholdings into the state property system. Many of the challenges of maintaining the registries are caused by statutory and regulatory straitjackets that provide little room for maneuver. In addition, Indonesia's risk-averse legal and regulatory culture impels administrative agencies to add steps and procedures to business transactions.

BPN is required to issue land certificates, when requested, to any person who has evidence of right to control a plot of land. Interviewees reported that registration of previously unregistered land is generally accepted based on documents issued and verified by the community. Denials are rare for registrations proposed by the community, except in cases of manifest error. Land maps often contain buildings, but not all maps are updated.

Apart from individual applications for registration of landholdings, BPN also conducts systematic registrations as part of its long-term effort to bring customary landholdings into the formal system. Expenses for systematic land registration are usually borne either by a particular public project or on a community self-funding basis. Numerous donors have collaborated with national authorities in property system projects. The Rural Development Institute completed a multi-year grant in 2004; the World Bank is involved in systematic land registration; the USAID Aceh project's LARAS activity is engaged in a community land mapping project; and the

Spanish government is working with the BPN through its Land Office Computer project to achieve shorter transaction times.

Although the BPN has established standardized procedures and described them in its brochures, frequent violations occur. Application denials require written justifications, but this requirement is not always followed. Often there are denials based on claims by third parties, which must be resolved through the courts.

The cost of land registration depends largely on the evidence needed to establish land rights. There are also expenses for surveying and mapping. Systematic registration is far cheaper than sporadic land registration.

BPN handles approximate three million transactions each year. There are 5,000 to 7,000 registration applications per month in the Jakarta region alone. According to a senior official, there were 10 problems of "major" significance and another 2,800 serious disputes in 2005.

BPN is afflicted with serious problems that cause uncertainty in real property transactions and can even disallow the rights of a good faith purchaser:

1. **Delays in registration** make it impossible to determine at the time of sale whether there are existing registered claims to the property.
2. **Duplicate and counterfeit certificates** are commonplace.
3. **Lost or missing land books:** Data on land ownership goes missing in land registration offices, due in part to organizational restructuring and physical relocation of the offices.
4. **Conflicting data** is maintained by different agencies, particularly municipal tax authorities. Sometimes the same plot of land is characterized or re-characterized by different agencies as agricultural/residential, forest, or military land.
5. **Lack of transparency:** It is extremely difficult to obtain information about ownership and other interests in property (i.e., liens, mortgages, and easements) through the Land Registry, which restricts or prohibits the provision of information to anyone other than the landowner.
6. **Lack of maps:** Many communities and locales do not possess a map for registration.

Land Conveyors (PPAT). The **Land Conveyor** (PPAT) is a notarial institution that serves as an intermediary between persons seeking to register property and the BPN. This unusual institution developed in order to help potential registrants navigate the difficult administrative processes related to transferring or formalizing property rights. By law, Indonesia's roughly 11,000 Land Conveyers perform a critical function and, like other branches of the legal profession, are regulated by the state and considered to be state officials.

Reportedly, all Land Conveyers are linked to BPN with web links and can submit documentation electronically. Whether this is the case is unclear. Typically, to register land one has to be in person at the BPN office. Web links certainly exist for notary offices to link in to the Department of Justice and Human Rights for registering companies and associations, for example. The land conveyor role is unique and cannot be easily filled by others, including attorneys, regular

notaries, or savvy amateurs. There are standard rates, but these are negotiable. The fees charged by notaries range from 0.2 to one percent.

In theory, notaries as a professional group are unified. Based on Law No. 30 of 2004 regarding notaries, the government only recognizes one notary association. Article 18 states that notaries who violate their obligations can be placed under sanctions that include written warnings, temporary discharge, and permanent discharge. Meanwhile, the PPAT role is regulated by Government Regulation No. 37 of 1998 regarding the Land Deed Officials Law, which established a PPAT notarial association to which all PPATs must belong. Under this law, PPATs have the authority to prepare land deeds. Article 62 of this Government Regulation states that Land Conveyors who violate this regulation can be placed under sanctions that include written warnings, temporary discharge, permanent discharge, and a compensation charge from parties who are affected by the notary's action.

An interview with a leading Land Conveyer indicated that, in addition to official fees, informal payments of up to one percent of the transaction value are embedded in transactions, apparently payable to staff at BPN. Notaries have a problem in that they cannot provide receipts for bribes, further limiting transparency in administrative procedures. A visit to a PPAT's office indicated that land conveyance is a lucrative profession. The respondent explained that she decided to become a PPAT after becoming a lawyer.

Courts. Delays in the court system can make it difficult to enforce real property security interests or obtain a prompt title determination. Civil cases relate to sale and purchase, lease agreements and transfer of rights over the land, and land border disputes. Many lawyers try to keep proceedings out of court to avoid delay, uncertain outcomes, and costs.

Court decisions in Indonesia are hard to predict. Many factors affect court decisions, and the authority of judges can be compromised. Communities seeking justice are frequently defeated. Other factors influencing court decisions are the motivations and honesty of the judges. To avoid lengthy court cases, alternative institutions have developed in Indonesia, especially arbitration as specified in Law No. 30 of 1999. This law has been effective in providing dispute resolution of land cases outside of the courts.

Supporting Institutions

Local government assessors. While each local government unit maintains a schedule of real property values, these data are not routinely updated and are not perceived as reliable. As a result, the local assessment property values are rarely used as the basis for real property fair market valuations, and can vary widely from jurisdiction to jurisdiction.

Surveyors. BPN employs a staff of 2,300 land surveyors nationwide to determine boundaries of land plots, prepare land registration maps, prepare lists of land, and prepare survey certificates (Government Regulation No. 24 of 1997, Article 14 paragraph 2). After mapping is completed, the surveyed land is numbered and calibrated. Because the land surveying needs of Indonesia are great (over 50 million parcels need to be formalized), more staff are required. Private contractors are an option.

Real estate professionals. Investment in the Jakarta real estate market provides returns that are relatively high for the region. These returns average 15 to17 percent, which is less than the 22 percent many in Indonesia were accustomed to prior to the Asian financial crisis. In Jakarta, many companies are engaged in the sale, purchase, and lease of property. These companies develop the methods of property transfer. Some apply a fee system based on a particular percentage in each transaction, while others apply a service payment before and after the transaction occurs, with a fee calculated based on the transaction price. Information on these brokerage agencies can be acquired at fairs and auctions and in advertisements displayed at the property locations.

Real estate financiers. There is an active mortgage market for upper middle class properties. Thirty-percent down payments are required, and financing is provided in rupiahs on an adjustable rate basis.

Zoning bodies. City planning offices of district governments, the Ministry of Regional Resettlement and Infrastructure, the Ministry of Forestry, and the BPN play a role in stipulating land use and spatial plans. Reportedly, coordination among these agencies is poor, and records regarding ownership of parcels are not shared. There is no systematic formal procedure for implementing rules and legislation pertaining to land use and spatial planning.

Social Dynamics

The people of Indonesia do not benefit from the convoluted, complicated property system created in 1960. The Basic Agrarian law's pitfalls include granting too much discretion to government officials. Most civil society groups want the Basic Agrarian law to include clear protections of private land and indigenous property rights, but support for this type of change is not unanimous. Some civil society groups are suspicious of private land rights and resist the idea that land should be a commodity.

There are no professional associations, such as lawyers' associations, broker associations, and mortgage bankers, that focus on real property. Academic experts provide training on rules and regulations through universities or at the request of special interest groups. In order to develop rules and legislation for real property in the future, it will be necessary to establish associations. The only special services available in this area in Indonesia involve the examination of real property. Trade and special interest groups such as the farmers' association must continue to press for rights in obtaining land. Professionals and consumers in the field of real property believe that supporting institutions available in the big cities are sufficient. However, supporting institutions in outlying regions are characterized as inadequate.

BPN and other agencies have been drafting new regulations and laws to amend gaps in the property system regime. However, government officials have not given stakeholders meaningful opportunities to critique and suggest changes to the drafting and implementation of law. This problem appears to stem from a lack of understanding of how best to incorporate outside advice and viewpoints into an internal drafting process.

According to one donor group, most law drafters associated with BPN lack the necessary training to draft good laws.[37] Reportedly, they do not fully understand the underlying societal need for regulation.

The Ministries of Forestry and Mining will not relinquish authority over the lands in their jurisdictions. The Ministry of Mining, which does not have direct authority over land, only has authority to issue permits for mining. Parties that need land are required to get a land permit from BPN. If the land is forestry land, the party must also secure permission from the Ministry of Forestry. Numerous complaints about the performance of various land registries include accusations of delay and poor data maintenance and retrieval. Counterfeit and forged certificates have led to allegations of serious improprieties.

The government receives technical assistance from various donor organizations to improve the legal climate and registration process, including assistance in drafting. For example, Hernando de Soto's Institute for Liberty and Democracy was recently invited to examine and make recommendations for Indonesia's property system.

To expedite land registration, the BPN office distributes brochures to the public during land registration programs. These are available in local Land Registry offices. In the BPN's ground-level information office there are posters that described the steps required for registering property. A helpful clerk explained that businesspeople who visit usually inquire about use rights, while individuals usually inquire about ownership rights. The office appeared to have many relevant laws and regulations available to the public. Registrants of real property may have concerns that the Registration Office is not transparent in terms of giving service, is non-cooperative, or is discriminatory. They may also feel that the registration process is too costly. Some users have given input to the land office service, but generally the organization has not responded well.

Although the Registration Office's internal plan for service enhancement is reviewed annually, the office is not formally responsible to the government or the public. The Land Office does not document its cost accounting and service quality or provide written records of its decisions about rules and legislation.

Policy on land concession and spatial planning is difficult to supervise; it is also difficult for agencies to be accountable to the central government and the public regarding the performance of many related institutions. Furthermore, there is no standard procedure to obtain input from the private sector regarding costs or expenditures and service quality.

[37] Rural Development Institute (RDI), *The RDI Report*, 2006. p. 2.

Recommendations

National Land Agency

- Educate interest groups on potential alternatives for fixing the Indonesian property system.
- Increase transparency of records so that information on land ownership is not held exclusively by BPN officials.
- Increase public access to the BPN registration systems. It is inefficient to require that the public use private intermediaries (i.e., PPATs) to register documents.
- Increase the pace of land registration in the informal, customary system. Consider cheaper and more efficient methods of surveying, such as using satellite imagery.

Land Notaries (PPATs)

- Encourage competition in pricing vis-à-vis the services of Land Conveyors and notaries.

Courts

- Improve training on enforcing the summary nature of extra-judicial foreclosures. Courts should demand a minimum threshold of documentary evidence to support a claim that an extra-judicial foreclosure sale was improperly conducted. Consider a change in the law to make extra-judicial foreclosures truly extra-judicial; there should be no need for the court to confirm the sale or for a court sheriff to conduct an auction.

Civil Society

- Encourage government officials, legislators, and civil society stakeholders to reach a consensus on proposed legislative reforms.

SECURED TRANSACTIONS

Introduction

Access to business credit is important to the growth of any economy, and collateral is important to access to credit. In Indonesia, when borrowers seek the privilege of doing business with funds offered by lenders, those lenders, like lenders all over the world, demand collateral as security.

Collateral exists in two broad classes: immovable property (land and buildings) and movable property (all other property, including intangible property). Lenders often prefer immovable as collateral, despite its many drawbacks. In underdeveloped economies, land law and mortgage markets are often cumbersome and very expensive. No matter how well an economy has developed, land may already be mortgaged to finance its purchase. Further, many credit-worthy borrowers do not own land to offer as collateral. Finally, land may be illiquid compared to many other types of collateral, such as crops, livestock, inventory, securities, and receivables.

Movable property as collateral has its own drawbacks. Any advantage of liquidity is offset by other risks, such as depreciation and the possibility that the debtor will sell or otherwise dispose of the property. Legal obstacles also exist. Legal rights in movable property as collateral are often much weaker than mortgage rights in land, even where land law is poorly developed and even though movable property may be more liquid than land. Fortunately, legal obstacles to credit are artificial creations that can be removed. When legal obstacles are removed, movable property as collateral can generate great leverage for business credit. For example, in the United States 70 percent of small business loans are secured by movable property.[38]

Collateral is a problem in Indonesia. A reported 31 percent of Indonesian small businesses do not apply for credit because they experience difficulties when asked to provide collateral; this is their most significant reservation. (Nine percent report that their greatest reservation is interest rates, and 11 percent are put off by complicated procedures.) Some prominent lenders to non-farm enterprises, on the other hand, limit their interest in collateral exclusively to land certificates, houses, cars, motorcycles, and time deposits.[39] Indonesia boasts a growing industry of non-bank financing firms, but the industry has gravitated toward consumer finance and credit card services. Despite the volume of receivables generated by consumer finance (which are highly liquid in value as collateral), the industry does not seem interested in factoring.

Financing by non-bank multifinance companies in Indonesia, 2005

	Factoring	Leasing	Consumer Credit Card	Consumer Finance	TOTAL
Rupiah (trillions)	1.4	19.1	1.8	45.4	67.7
Percent	2.0	28.3	2.2	67.5	100

Source: World Bank, *Unlocking Indonesia's Domestic Financial Resources*, p. 183

[38] Commercial Finance Association Annual Asset-Based Lending and Factoring Surveys, 2005.

[39] World Bank, *Revitalizing the Rural Economy* (2006), pages 41-43. By contrast, only nine percent of businesses were concerned about interest rates, and only 11 percent were concerned about complex procedures.

Law can help make collateral more attractive to lenders in at least four ways. First, law can *refrain* from imposing formalities, delays, and cost upon the act of creating security rights in collateral. Second, law can *require* disclosure of minimal information about secured transactions to the public, so that prior security rights can be discovered by prospective buyers of property and prospective lenders who may consider taking property as collateral. Third, law can *anticipate* conflict among creditors and fairly resolve the conflict in advance of any actual dispute. Fourth, law can *minimize* the time and cost associated with enforcement against collateral in the event of the debtor's default. If collateral is more attractive to creditors, more credit, on better terms, will be available to the credit-worthy.

Legal Framework

Overview of choice of transactions. Indonesian law on the use of movable property as collateral is marked by a high degree of formalism. A number of transactional forms are illustrated below. When movable property is offered as collateral, a willing lender must determine which legal form to select. For some types of collateral there may be a choice of legal forms. Legal requirements and transaction costs vary from form to form: some require notarial deeds; some require registration; some require third-party participation; and some require payment of rents. In selecting the form, creditors must be conscious of more than the time and cost involved in the various alternatives. Remedies available to a creditor upon default also vary from form to form. Remedies under some forms may be stronger than remedies under others, and the cost of enforcement may vary.

Consider the following forms by which movable property may secure an obligation:

Conditional sale.[40] Business equipment may be purchased on credit under a conditional sales agreement. The seller retains ownership rights to the equipment until the buyer makes all payments and otherwise completes the agreement, at which time title transfers automatically to the buyer.

- *Formalities of the agreement.* A conditional sales contract consists of a simple, written agreement.
- *Priority.* Presumably, the seller's retention of title guarantees the seller priority in the goods against other creditors, although it is unclear whether Indonesian courts would view the conditional sale as a secured transaction rather than a deferred sale. If treated as a secured transaction, a seller may face stiffer threats against, for example, tax liens and holders of execution orders.
- *Publicity.* There is no source of public information about conditional sales. Neither a prospective buyer of goods nor a prospective lender who is offered goods as collateral has any objective and legally certain source of information as to whether the goods are subject to a prior conditional sale.
- *Enforcement.* Upon the debtor's default, the seller has the right to repossess the goods and the right to dispose of them to satisfy the obligation in whole or in part. The buyer is liable for any deficiency.

[40] Dr. Sudargo Gautama, *Indonesian Business Law* (Jakarta: Citra Aitya, 1995), p. 591.

Pledge.[41] Tangible movable property may secure an obligation by means of the classic pledge. A pledge is a right to specific property of the pledgor, given by the pledgor to the pledgee.

- *Creating a pledge.* It is easy to create a pledge. A simple agreement is required; it need not be made in writing. The agreement may be proved by any admissible evidence.
- *Priority.* A pledgee who maintains possession of the object of a pledge has a preferential right to satisfy the obligation from proceeds of the sale of the pledged object.
- *Publicity.* There is no registration or other publicity mechanism for the pledge, but the delivery requirement prevents prospective creditors from being deceived by the status of pledged goods held out by the debtor as potential collateral.
- *Enforcement.* Upon the pledgor's default, the property, or the "object of the pledge," may be disposed of by the pledgee to satisfy the obligation.

The pledge is legally effective only while the pledgee maintains physical possession of the object of the pledge (or while the object of the pledge is in the custody of a third person agreed to by the pledgor and the pledgee). The serious disadvantage of the possession requirement is that in most commercial circumstances the debtor must have the right to possess and use the property in connection with its business (as is the case, for example, with business equipment, vehicles, and inventory). As a practical matter, the pledge is suitable in modern commercial practice where the object of the pledge is a negotiable instrument, cash, or, to a limited extent, some inventory finance arrangements where it is convenient for the pledgor to conduct business while inventory is in the hands of a third party. To complicate matters, a negotiable instrument, though it may be pledged, may also be assigned by a debtor without delivering possession under the civil code provisions on assignment (Article 613), discussed below.

Warehousing.[42] The law on warehouse receipts codifies and builds upon customary practice in certain types of inventory financing, especially where commodities (e.g., crops, extracted minerals, and raw materials) secure an obligation. The law defines the rights of parties more elaborately than does the civil code. The warehouse receipt itself is a piece of registered tangible property. The receipt can be bought and sold, and it can serve as collateral. While new, the warehouse receipt law appears to be gaining popularity rapidly in the limited commercial circumstances for which it is suitable.

Consignment. In customary practice, goods may be delivered from one person (the consignor) to another (the consignee) for the purpose of sale under the consignee's business name. The consignor may simply be the owner of the goods, retaining ownership until the goods are sold by the consignee (a "true consignment"). Alternatively, the consignor may be, in effect, the

[41] Pledge is governed by the civil code (Articles 1150–1160). Note that some Indonesian lawyers may resist referring to the conditional sale (also a financial lease) as a "secured transaction." The objection is based not on grounds of commercial practicality (seller/"lessor" retains title to secure an obligation to pay an agreed purchase price) but rather on technical legal grounds (seller/"lessor" chooses to defer sale or title, granting the right of use to the buyer/"lessee" in the meantime but without creating a secured obligation). Conditional sale is governed in general terms by the Indonesian civil code (Articles 1253–1267) and more specifically by custom and practice.

[42] Warehouse Receipt System Law, (Law no. 9, 2006).

consignee's inventory financier, retaining title to the inventory to secure payment (a "consignment for security").

- *The consignment agreement.* Under this non-statutory transaction, a simple agreement appears to suffice, though ultimately a court will determine formalities in the event of a dispute over the effectiveness or validity of the agreement.
- *Priority.* Because it is a transaction developed by custom, there are no statutory rules on priority among consignors and other creditors with claims against property of the consignee. Consignors presume that their ownership rights protect them from other creditors, but it is unknown whether Indonesian courts would consider the transaction a secured transaction and dilute the consignor's ownership right, for example in case of a conflict with the holder of a registered fiduciary guarantee (discussed below).
- *Publicity.* There is no registry or public notice for disclosure of information about the consignments.
- *Enforcement.* Upon the consignee's default, and in the absence of the consignee's cooperation, the consignor must rely on the courts for general relief.

Assignment.[43] A person may secure an obligation by assigning to a creditor the right to receive money from another person.

- *Creating an assignment.* The right to payment may be in the form of a negotiable instrument, in which case the assignment is effective upon delivery of the instrument to the assignee. In other cases, the assignment is effective against the obligor only when a written agreement is executed and when the obligor is notified.
- *Priority.* The civil code article does not address the question of multiple assignments of the same account. One common rule in civil law jurisdictions is to award priority to the assignment on the basis of the first notice to the obligor on the account. It is unclear what rule Indonesian courts would follow.
- *Publicity.* There is no registry or public notice that would disclose information about the transaction to prospective creditors who might consider taking the account as collateral.
- *Enforcement.* The civil code provides no aid to the creditor for collection of assigned accounts upon default by the assignor.

Modern receivables financing techniques frequently use bulk assignment of accounts, including the assignment of accounts created after the date of the assignment. The requirement to notify the obligor is a substantial obstacle to modern techniques. Notification to obligors is inefficient in bulk receivables financing transactions. Further, notification may be unnecessary where, upon default, the assignee has the ability to collect assigned accounts without directing the obligor to pay in a different manner than required under the underlying agreement. The civil code provisions for assignment are inadequate for many modern commercial arrangements where receivables serve as collateral.

[43] Assignment is governed by a very briefly article 613 of the civil code.

Fiduciary guarantee.[44] A person may secure an obligation with tangible and intangible property, whether currently owned or acquired after the date of the agreement, by a form known as "fiduciary guarantee." A borrower transfers ownership rights in collateral to the lender. The creditor holds title to the property until the debtor's obligations are performed.

- *Creating a fiduciary guarantee agreement.* The agreement takes the form of a notarial deed and must include specific information about the transaction as provided by law. The fiduciary guarantee is not effective until registered. Therefore, it may not be enforced against the debtor until registered.
- *Priority*. The law permits only one fiduciary guarantee per "item" of collateral. Presumably, therefore, conflicting transfers are impossible. Nonetheless, the law provides that priority among competing fiduciary guarantees is measured by the first to register. No priority scheme is provided for conflicting claims from other sources, whether consensual (e.g., by assignment or pledge) or non-consensual (e.g., judgment claims or tax liens).
- *Publicity.* A public registry established in the Ministry of Justice receives, maintains, and reports notices of fiduciary guarantees. There is a registry in each region of Indonesia. Registration takes place in the district where the debtor is domiciled.
- *Enforcement*. Upon the debtor's default, the creditor is most likely to be limited to enforcement through the execution offices supervised by the courts, even though the law anticipates more streamlined results. See the discussion below.

The fiduciary guarantee applies to a wider range of collateral than other forms, and may apply to property acquired in the future. Therefore, it is the most common method of securing business credit (with the possible exception of conditional sale, which for practical purposes is limited in use to the purchase of new equipment). Fiduciary guarantee is discussed at greater length after this overview of available Indonesian forms for securing obligations.

Royal Decree S57/1896.[45] The use of crops as collateral is available to ethnic groups who grow crops destined for European markets. Today, customary practice assumes that U.S. markets are also included. The decree assumes that the crop is destined for a processor/financier that will deduct the value of the crop from outstanding debts upon delivery. The formalities are found in Royal Decree S57 of 1896.

- *Creating security in crops.* The security right is a property right created by simple agreement. The property right may be granted in growing crops and it continues in the crops after harvest.
- *Priority.* The decree is silent on the inevitable priority dispute between the processor/financier and an intervening third party buyer of the crops. Apparently, the risk of multiple financiers is low in ordinary Indonesian practice; the decree is also silent on that possible dispute.

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[44] The fiduciary guarantee is governed by Law No. 42, 1999, which codifies and elaborates on prior customary practice grounded in Dutch legal tradition.

[45] Gautama, p. 622-625.

- *Publicity*. There is no notice system to warn other crop financiers or buyers of a farmer's growing or harvested crops.
- *Enforcement.* As long as harvested crops reach the processor/financier, the decree is self-enforcing: the financier deducts the value of the crop from outstanding debts.

Post-dated checks.[46] Indonesian lenders commonly obtain post-dated checks from debtors to "secure" obligations. Upon default, the lender attempts to cash one or more of the checks. Because the penalty for passing a bad check can include imprisonment, the practice is effective in many commercial circumstances. However, a check constitutes a personal promise to pay and not the transfer or reservation of a property right to secure an obligation. Consequently, the practice is merely noted here and is not otherwise included in the analysis of the secured transactions legal framework.

The following table indicates the practical applications of the various forms of collateral described above. Where a type of collateral may be encumbered by use of more than one form, the mere choice of form may require analysis of the cost of meeting statutory requirements (borne by the debtor), the degree of certainty as to priority among competing claims, and the strength of remedies available upon default (of concern to the creditor).

	New Equipment	Existing Equipment	Inventory	Instruments	Crops
Conditional Sale	X				
Pledge		X	X	X	
Warehousing		X	X		
Consignment			X		
Assignment				X	
Fiduciary Transfer		X	X	X	
Decree S57/1896					X

Conditional sale may offer the highest degree of certainty to the creditor with respect to priority over competing claims, but it is only suitable for a limited number of transactions (i.e., those involving the purchase of equipment). The fiduciary guarantee applies to a wider variety of collateral and attempts to protect creditor rights upon default to the same degree as the conditional sale, but the form involves far greater costs, as discussed below. Other forms offer commercial advantages, but legal obstacles limit their applicability: assignment requires notice to the obligor; pledge requires delivery of tangible goods; crop security extends to ethnic groups growing crops for European markets; and consignment has no statutory basis and is therefore of little use in transactions of significant value.

The Fiduciary Guarantee Law (Law no. 42, 1999). The Fiduciary Guarantee Law requires elaboration because (1) fiduciary guarantee applies to the widest range of collateral, (2) it is used more frequently than any other form (except possibly for the conditional sale), and (3) its basic

[46] Idem, p. 595-598.

contours—registration, priority, private enforcement—resemble general principles of modern secured finance.

The fiduciary security law contains a number of commendable progressive provisions:

- *Future-acquired property.* Collateral may consist of future-acquired property (Article 9), although this advantage is limited by two requirements: the value of collateral must be stated in the agreement and collateral must be specifically described in the agreement and at the registry.
- *Future debts.* Collateral may secure existing and future debts, although the amount of secured debt must be known at the time of the agreement (Article 7).
- *Proceeds.* A fiduciary guarantee automatically carries with it a grant of security to proceeds—property received by the debtor in exchange for the collateral (Article 10).
- *Streamlined enforcement.* A fiduciary certificate (produced upon registration) is an executory document (Article 15), meaning that, upon default, the creditor may exercise enforcement rights by going directly to execution and without first obtaining a judgment against the debtor.

Form and contents of the fiduciary guarantee agreement. A fiduciary guarantee agreement must comply with a number of formal legal requirements. Some of these requirements are anti-commercial in effect, imposing costs on borrowers, risk on lenders, or both.

First, the agreement must be in the form of a notarial deed (Article 5). Thus the state, in the form the public office of the notary, imposes itself between parties to a private agreement. (The state will intervene again later, at the registry, in the form of an attending notary.) The services of the notary add cost and delay to the process of arranging the terms of a commercial loan. The role of the notary is examined below.

Second, the agreement must state the amount of money secured by the fiduciary guarantee (Article 6). If the collateral secures a future debt, the amount of the future debt must be known and stated in advance (Article 7). The amount may be in Indonesian or foreign currency, but the requirement of the amount, by itself, is enough to hamper floating lines of credit. In efficient inventory financing arrangements, the amount secured by collateral may be intended by the parties to fluctuate. The amount may not be known at the time of the agreement. If the parties do know the amount, they may plan for it to increase after the execution of the agreement by an as-yet undetermined amount. The law is silent on the consequence of failure to state the amount, the consequences for stating it incorrectly, or the consequences for failing to amend the agreement or the registration (which also lists the figure) if the amount is increased. The requirement itself, and the cumulative uncertainty surrounding it, is enough to dampen the credit climate, especially for inventory loans.

Third, the agreement must state the value of the collateral (Article 6). In efficient business finance arrangements, the value of collateral may not be known or may be susceptible to assessment only at unnecessary and unknown expense. The collateral may consist of future-acquired property whose value cannot be known at the time of the agreement. The law does not specify the consequences of failure to state the value of collateral, of stating it mistakenly, or of

stating it differently than a court may later determine the value. The result is uncertainty for borrowers and lenders, further clouding the credit climate.

Fourth, registration is required to create the creditor's fiduciary right. This requirement places the registry, a public office, between the parties to each security agreement, creating expense and delay at best and opportunities for rent-seeking at worst. Moreover, when registration is necessary to create property rights, then registration, no matter what the cost, must precede enforcement against the debtor. Practitioners often avoid the burdens of registration until enforcement becomes an issue.

General security interests. General security interests are crucial to modern commercial finance. Borrowers and lenders need freedom to agree that collateral may consist of all or part of a general class of movable property. Collateral is more attractive to lenders, and transaction costs are minimized, if a borrower can give a general security interest, for example, in "all equipment" or "all inventory" of the enterprise. Practitioners would like to believe, and they report a vague sense, that the fiduciary security law authorizes general security interests, but they do not act in accordance with this sense. Rather, they act as though the law requires collateral to be identified and described specifically. Indeed, the law nearly always refers to collateral by use of the word "item." A fiduciary is defined as transfer of ownership of "an item." Fiduciary security is defined as a security right over "an item of movable property;" the agreement must contain a description of "the item;" a fiduciary security may be granted over "one or more units or types of an item."[47] The definition of "item" does not state or imply that an item may be a class of property (Article 14).

As a practical matter, collateral must be described specifically under the fiduciary guarantee law. The law is certainly one of the causes for this practice. Another cause may be that fiduciary guarantee existed in customary practice before it became the subject of Law no. 42 of 1999, and specific descriptions were a feature of customary practice. Without an explicit statutory authorization of general collateral descriptions, which is absent in the law, practitioners act prudently when they behave as though the customary practice has not been modified by the legislative act. The registry also reinforces the practical need for specific descriptions by imposing required forms that demand itemized collateral descriptions.

Without explicit authorization for general security interests, lenders cannot be certain that fiduciary guarantees would be enforced to cover general security interests. Few if any lenders will take the risk.

Priority of claims. Lenders want to know that their rights in collateral can stand up against the claims of competing creditors. Unfortunately, a lender's claim to collateral may encounter a variety of challenges. Potential scenarios include:

- A lender who has taken a fiduciary guarantee of heavy machinery discovers, upon default, that the machinery is subject to a conditional sale.

[47] See, for example, Articles 1, 6, and 9.

- A lender who has taken a fiduciary guarantee of receivables discovers, upon default, that the receivables have been previously assigned under the civil code.
- A pledgee who takes possession of valuable property later learns that a prior registered fiduciary guarantee names the property specifically.
- A lender who takes a fiduciary guarantee in inventory of a department store later learns that a judgment was previously entered against the department store and an execution order against the inventory has been issued.
- A lender takes a fiduciary guarantee in movable property of a firm that later fails to pay taxes, leading to a tax lien against the firm's movable property (including the lender's collateral).

These are disputes among persons whose interests arise under multiple forms. Indonesian law does not resolve any of these "inter-formal" conflicts. Indonesian law does not clearly resolve conflict between a lender and creditors whose interest arises without the debtor's consent, as when the tax authority asserts a lien for unpaid taxes, or a judgment creditor attempts to execute against collateral. The rights of the creditor are strong in the context of bankruptcy, but prior to bankruptcy there is great opportunity for confusion and dispute.

For some (but not all) forms, the law creates a preference in favor of the lender against competitors whose interest arises *within the same form*: the pledgee with possession wins over pledgees without possession; the first holder of a fiduciary guarantee to register wins; and (presumably) the first assignee to notify the obligor of an assignment wins over assignees who notify later. But there is no priority scheme to resolve disputes among creditors whose claims cut across the system of legal forms.

The fiduciary guarantee law is the clearest about priority disputes. The first to register has priority over fiduciary guarantees that are unregistered or that are registered later. The law also attacks the problem in yet another way. A debtor is prohibited from granting multiple fiduciary guarantees over the same property without the consent of prior creditors and commits a crime by doing so (arts. 17 & 36).

Indonesian law does not adequately minimize the risk of competing claims to collateral.

Buyers of collateral take the collateral subject to a fiduciary guarantee (art. 20), unless they buy from a seller's inventory and pay the market price (art. 22). The other forms of transaction do not provide for the rights of buyers.

When lenders are sure of their priority against competing creditors, access to credit expands. To the extent they are unsure, credit is available in less quantity and on less favorable terms. In a well-functioning secured transactions legal system, priority rules minimize risk by anticipating and resolving conflicts before they happen. Indonesian law does not adequately minimize the risk of competing claims to collateral.

Enforcement. A fiduciary guarantee certificate, issued by the registry, has "executory force" (art. 15), meaning that upon default the creditor may enforce against the collateral without first going to court for a judgment against the debtor. This provision undoubtedly confers a great savings in

time and money in enforcement situations. However, actual enforcement has yet to be accomplished.

Upon default, the creditor, armed with the executory force of the fiduciary guarantee certificate, has three options. First, the creditor may proceed to execution. Execution requires interaction with the judicial system, perhaps by obtaining help in repossessing the collateral from the debtor, and certainly through judicially supervised auctions the execution offices conduct. This procedure is slow and expensive. Second, the property may be sold at a public auction that the judiciary does not supervise, presuming that the creditor can legally take possession of the collateral. The debtor's cooperation is required, but usually not forthcoming. Third, if the debtor agrees and if a one-month moratorium is observed during which two newspaper notices are published, the creditor may sell the property privately.

The least practical option – judicially supervised execution – is typically the only option, according to Professor Arie S. Hutagalung.[48] Creditors can rarely take possession of collateral with the debtor's cooperation. Opportunities for repossession by "self-help" are limited to a few types of collateral (such as vehicles) and the "self-help" method is neither established nor accepted in Indonesia. Therefore, generally creditors cannot look forward to less expensive enforcement methods such as public auction outside of judicial execution, and private sale. Of course, public and private sale would be more effective options if judicial process were available to give possession to the creditor, rather than to the execution office.

A disposition of collateral that fails to comply with the law is void (art. 32). This may have disastrous results for the buyer of collateral at an auction. For example, suppose that the debtor challenges the sale of collateral by the creditor and persuades a court that the procedure was defective. The sale is void and therefore the buyer cannot have taken title to the goods. This risk must be taken into account by buyers, resulting in depressed sale prices whether ultimately there is a challenge to the sale or not. Debtors are responsible for deficiencies in the secured debt after the sale. Therefore, debtors are casualties of the process along with the creditors.

Remedies under the fiduciary guarantee law presume that collateral is tangible, such as equipment and inventory. Except for authority to sell securities on an established market, the law does not tailor remedies to any specific type of collateral. For example, if the collateral is a negotiable instrument in the creditor's possession, there is no authority by which the creditor may negotiate the instrument without judicial process. If the collateral is receivables, there is no authority to collect the receivables without judicial process.

The fiduciary guarantee law fails to provide enforcement tools necessary for the enforcement of property rights that debtors voluntarily give to creditors.

[48] Arie S.Hutagalung, *Execution on Fiduciary Security under the Law no. 42 of 1999 Regarding Fiduciary Security* (1999).

Implementing Institutions

The Fiduciary Guarantee Registry. The registry is the heart of a modern secured transactions legal system. A modern secured transactions registry serves *only* two purposes:

- *Notice.* The registry receives notices of secured transactions, stores the notices, and reports them to the public upon request. The most common requests come from prospective creditors who want to know the status of proffered collateral and prospective buyers of property who want to know whether the property is already encumbered. Notices must be easily and inexpensively available for public inspection.
- *Priority.* The date that a notice is registered may establish the priority date by which competing claims to a debtor's property are measured, depending on the applicable priority rule.

The Indonesian Fiduciary Guarantee Registry does not fulfill the role of a modern secured transactions agency.

The Indonesian Fiduciary Guarantee Registry does not fulfill the role of a modern secured transactions registry. First, the registration date cannot provide adequate priority assurance due to lack of sufficient priority rules, as described above. Second, the registry operates in secrecy, contrary to the inherent requirement of open public records. Third, registration is slow and costly.

Public Records. Registry records are public records under article 15 of the Fiduciary Guarantee Law. However, the national registration office and the Jakarta district office provide no instructions to the public on how to search the records. When asked about procedures for searching records, officials stated verbally that an application for a search must be made in writing, directed to the Director General at the Ministry of Justice, stating the purpose for the search and attaching the authorization of the debtor to perform the search. Officials do not recall a search having been requested or authorized.

If a request were authorized, the registry has no practical means of performing the search or facilitating the public in doing so. Although all information required in the security agreement is typed into a computer program for the purpose of printing the fiduciary guarantee certificate, none of the information is stored in a searchable database. Therefore, the registry's computer records are not useful to prospective creditors and buyers of collateral who need information on the status of a debtor's property. All of the information required in the security agreement is handwritten into a ledger. Registrations are entered on the ledger in chronological order. No index of the ledger entries is created. Consequently, the easiest way for a prospective creditor to search for a prior, conflicting fiduciary guarantee, if registry officials would permit it, is to read all of the historical ledger entries. The only alternative method would be to examine each of the file folders containing the original applications and supporting documentation. None of the practitioners interviewed for this report has attempted a search of the records of the Fiduciary Guarantee Registry.

Registry scrutiny of records. The official elucidation of the Fiduciary Guarantee Law (art. 13) provides that the registry is not to verify the accuracy of information submitted for registration. The registry is merely authorized to review the registration application for completeness. In fact, the registry requires extensive documentation with registration applications, including a copy of

the fiduciary guarantee agreement and perhaps proof of ownership of items of collateral. Registration officials report that suspected typographical errors would result in rejection of an application. The director of the registry personally reviews each guarantee certificate for accuracy, including typographical accuracy, and personally signs each certificate.

Less than one page of text is entered into the registration ledger, yet Jakarta registry officials estimate the average registration processing time at three weeks.

Fees. Official filing fees are nominal and established by regulation. The fee charged for services by the notary public is negotiable but subject to competition among notaries. An unofficial registration fee is also negotiable, based on the amount of the secured loan. Frequently the notary assists in the negotiation, collection, and delivery of the unofficial fee.

Fiduciary Guarantee Registration Volume: Jakarta Province	
2001	5,260*
2002	11,609
2003	13,023
2004	9,515
2005	11,663
2006	8,660

*Registrations per year
Source: Fiduciary Guarantee Registry, Jakarta Province

Volume of Registration. There is a Fiduciary Registration Office in each of the provinces. The provincial registries provide monthly reports to a central office in Jakarta. The reports are not available for public inspection. While it was not possible to obtain records of registration volume in each of the provinces, the Jakarta office researched its records to provide annual volumes in the Jakarta province.

Registration officials report that the office is understaffed, under-equipped, and under-funded. The Jakarta office has eight staff members devoted entirely to fiduciary guarantee, with only five computers at their disposal. The average number of registrations per year in Jakarta, from 2001 through 2006, is less than 10,000. Assuming a 220-day work year, the Jakarta office receives daily volume of 45 registration applications. Each staff member, therefore, handles an average of five to six registrations per day.

The limited use of secured lending under the fiduciary guarantee law may be attributable to factors that include the following:

- Time consuming formalities in creating security, registering a transaction, and enforcing against the collateral.
- Expense attributable to official and unofficial fees and services.
- Inability to determine whether prior fiduciary guarantees exist covering the same property.
- Lack of certainty about priority in the event of conflicts with holders of rights under other forms, and against non-consensual property rights that may arise before or after a lender takes a fiduciary guarantee.

In a district of roughly 10 million people, Jakarta, the capital of a country of more than 240 million people, might be expected to see high registration levels if secured lending law were optimally, or even approximately, configured to the needs of borrowers and lenders. Instead, registration volume is small. Practitioners report that fiduciary guarantee is reserved for a small number of large transactions relating to a small number of parties who can afford the services and fees. Therefore, fiduciary guarantee law is not widely available to Indonesian businesses.

Supporting Institutions

The office of Notary Public. The notary public plays an important role under the Fiduciary Guarantee Law in that a fiduciary guarantee agreement must be in the form of a notarial deed (art. 5). The notary public reviews the agreement and may prepare the registration application. When accepted by the registry and a fiduciary guarantee certificate is granted, the notarial deed has "executory force," meaning that upon default there is no need for the creditor to obtain a judgment against the debtor. The creditor is one step closer to execution than otherwise would be the case.

The notary public often acts as an intermediary between the parties to the agreement and the registration office. Time may be saved if the notary public delivers the application to the registry and facilitates the transaction. According to one notary, the Indonesian national association of notaries has agreed with government officials to work with registry officials in determining, collecting, and delivering rents. All fees, formal and informal, are negotiable.

The use of the notarial deed in creating security in movable property is not a feature of any modern model for secured transactions and is not recommended by any international body or donor.

Social Dynamics

The law on movable property as collateral is not a subject of high interest in the public discussion of modern commercial law and practice.

In general, mechanisms for developing legal reform proposals are well developed in Indonesia. Parliamentary initiatives are developed through a support unit (BALEG) that employs professional expertise and consults with professional associations and the public. The executive branch develops proposals with assistance from a Law Commission that takes assignments from the president and offers proposals and policy options. The Law Commission has six members

that may call upon various resources in developing proposals as requested by the president. However, movable property as security is not and has not been a focus of reform efforts at these institutions.

Practitioners and academics do not consider movable property as a serious form of security in Indonesia, except in the form of (1) conditional sales or finance leases; (2) commodities and inventory that can be controlled through the warehousing system; and (3) receivables through the fiduciary guarantee where large sums are at stake. Nonetheless, professional associations, trade associations, and credit organizations appear not to be interested in pursuing reform in this field of commercial law. Among practitioners and academics there appears to be little understanding of models and techniques for secured finance, other than Indonesian black letter law and traditional Dutch civil law.

Recommendations

- While broad legal reform is needed, incremental steps may be taken while broader reform is discussed and developed. Technical requirements of the various secured transactions forms should be analyzed for their commercial practicality. The test of each formal requirement should be whether it promotes commerce. Where legal technicalities fail to promote commerce, legislative proposals should be advocated to eliminate them. Examples of unnecessary formalities include:
  - The requirement that a fiduciary guarantee agreement be drawn in the form of a notarial deed
  - The requirement that collateral be described specifically
  - The requirement that agreements and registration applications contain the value of collateral and the amount of the secured debt
  - The requirement that obligors on assigned accounts be notified of the assignment.
- A broad discussion about modern secured transactions financing law and policy should be initiated and moderated among private sector stakeholders and interested NGOs. Policy proposals and legislative solutions should be developed and brought to the attention of policy-makers in the executive and parliamentary branches of government. Private sector stakeholders should prepare for an advocacy role in accomplishing legal reform. The following are key themes that should be included in the discussion:
  - At least for the purpose of notice and priority, the various forms should be treated in the same manner (e.g., conditional sale, assignment, consignment, fiduciary guarantee). A search of registry records should reveal information about any of these transactions.
  - Priority rules must anticipate conflict among secured creditors no matter what form of transaction was selected. The priority rules must resolve the potential conflict in a manner that promotes commerce. Conflict among holders of non-consensual property rights should be included in the priority scheme (e.g., judgment holders and tax lien holders).
  - Comprehensive registry reform is necessary to promote a healthy environment for secured lending.

- Registration should not be a step required merely to transfer collateral rights from one person to another. People should be free to transfer property rights without intervention by or permission from a governmental body.
- Registration should not be a step required for enforcement of property rights against a debtor. Registration should be merely a requirement for asserting a claim against third parties where appropriate under properly drawn priority rules.
- Registry records must be truly open to the public so that buyers of property and prospective secured creditors may determine whether a prior legal claim to property may exist.
- The public nature of registry records must be supported by modern technology by which records are indexed in a database for convenient search by any member of the public. Regional and international models for internet-based searching should be examined and implemented.
- The registry must simplify registration procedure and abandon paternalistic controls over information submitted for registration. Regional and international models for internet-based registration should be examined and implemented.
- Enforcement of secured creditor rights must be strengthened.
- For tangible property, the creditor's right to possession upon default must be given meaningful effect through streamlined judicial process.
- Non-judicial enforcement techniques should be authorized and tailored to the appropriate type of collateral. For example, upon default and without judicial intervention, the law should authorize the creditor to negotiate an instrument, collect on receivables, and take control and dispose of goods subject to a warehouse receipt or bill of lading. Delay tactics by the debtor must not be tolerated, though the debtor should be entitled to compensation for any abuse of authority by a creditor.

BANKRUPTCY LAW

Introduction

An economy that relies on business credit for growth must have a legal system that enforces obligations. Bankruptcy law is an integral party of such a legal system. When a business is no longer viable, its creditors must rely on bankruptcy law and various supporting institutions to salvage their claims fairly, predictably, efficiently, and transparently.

The text of Indonesian bankruptcy law attempts to accomplish these goals. As a tool to enforce obligations and promote commerce, the bankruptcy law offers creditors the legal tools they need to resolve the claims of a bankrupt debtor and to do so in a fair manner. Further amendments to black letter law will yield incremental benefits compared to the substantial benefits that may be accomplished through administrative reform.

When an NGO attempted to study the performance of bankruptcy policy, researchers found that many statutorily required records were not kept.

The capacity and professionalism of implementing institutions is a significant obstacle to efficient administration of bankruptcy law. While progress has been made since the advent of recent legal reforms, judges and curators cannot fulfill their roles properly under present circumstances and with present skill levels. Record-keeping and the commitment to openness of public records are great challenges for those who administer bankruptcy law. When an NGO attempted to study the performance of bankruptcy policy, researchers found that many statutorily required records were not kept. Where records were kept and were defined by law as freely available public records, access was often denied. Curator reports, access to which is crucial to fair administration of bankruptcy law, were often not filed and rarely made available for inspection. Creditors with claims in a bankruptcy case may have as much difficulty gaining access to information as academic researchers. All this suggests that creditors do not view bankruptcy judges and curators as honest brokers, which they must be if the system is to work. Until substantial reform is achieved, the resolution of most creditor claims will likely be left to informal workarounds and workouts, in which some creditors will exert undue influence over others. Institutions must improve if Indonesia is to take advantage of the opportunity that the black letter law offers.

The level of recovery may also deter the use of bankruptcy law. Creditors perceive that curators do not aggressively pursue debtor assets, and disposition of the assets is inefficient, yielding low levels of proceeds. In a study of asset recovery in bankruptcy since 1998, secured creditors recovered about 24 percent of their claims, compared to 18 percent for unsecured creditors.[49] According to the study, low asset recovery is attributed by creditors to: (a) poor transparency and accountability; (b) lack of professionalism among officials; (c) difficulties in discovering and controlling debtor assets; (d) problems in allocating and distributing the proceeds; (e) problems in selling assets; (f) failure to take full advantage of the law's legal tools; and (g) lack of understanding of the new law and regulations.

[49] Indonesia Anticorruption and Commercial Court Enhancement Project (In-ACCE) (2007). *Bankruptcy Study on Asset Recovery*, p. 28

	Involuntary Bankruptcy	Voluntary Bankruptcy
1998	30	1
1999	100	0
2000	81	3
2001	60	1
2002	37	2
2003	36	2
2004	49	2
2005	38	6
2006	57	2
2007*	20	4
TOTAL	**508**	**23**

*As of April 13, 2007

Source: Bankruptcy Study on Asset Recovery (In-ACCE, 2007), p. 13.

The above table shows use of the bankruptcy law since 1999. Peak use occurred after the Asian financial crisis. However, on the whole the lesson to take from the table is that in Indonesia bankruptcy law is not seen as a serious tool for enforcement of obligations.

Institutional development efforts would have a direct effect on the long-term efficacy of the bankruptcy legal system.

Legal Framework

Until 1998, Indonesian bankruptcy law was governed by 1904 regulations that followed the Dutch law of the time.[50] In response to the Asian financial crisis, and with assistance from the IMF and other donors, Indonesia reformed bankruptcy regulation in 1998. Parliament adopted further reforms in the current law on bankruptcy, Law no. 34 of 2004.

The criteria for filing a petition are simple (art. 2). If a debtor has two or more debts, one of which is in default, a petition may be filed by the debtor or one or more of the creditors. Petitions are filed with the commercial court, a recently created institution whose judges were experienced judges on the district court bench. The law covers regulated institutions such as banks and stock exchanges and state-owned enterprises. Petitions against these entities must be filed by statutorily defined authorities.

[50] A thorough understanding of bankruptcy practice, even after recent statutory reforms, requires understanding of the 1904 regulatory background, a description of which is beyond the scope of this chapter. For a good discussion of the subject, see Gautama, p. 547-561.

A hearing on a petition is required within 20 days of its registration, which may be extended for sufficient cause for no more than an additional 25 days (art. 6). A decision is required within 60 days of registration of the petition (art. 8). The decision contains an appointment of a supervisory judge and a curator (art. 15).

Secured parties may execute their rights against the debtor "as if no bankruptcy occurred" (art. 55). This rule applies to any creditor with a lien, fiduciary security under Law no. 42 of 1999), security right (which is undefined), mortgage, or "other collateral rights" on property, which presumably includes pledge, assignment of claims under civil code section 613, and perhaps other transactions. The curator may release collateral to a secured party at any time (art. 59). A secured creditor who executes on collateral must account to the curator for its disposal, and must remit any surplus over the amount of the secured claim; the creditor has an unsecured claim for any deficiency (art. 60).

While the rights of secured creditors are strong and clear, there is ambiguity about priority between unsecured creditors and holders of preferential rights, such as wage claims. Creditors and their attorneys report that this issue has caused delay and confusion in a number of bankruptcy cases.

The supervisory judge administers the case and oversees the activities of the curator, while the curator administers the bankruptcy estate. The supervisory judge is in charge of meetings of creditors. These functions are described in detail later in this chapter (see Implementing Institutions). The court decision may be appealed, but actions taken by the curator while the appeal is pending remain valid and binding upon the debtor (art. 16).

The curator has broad powers and responsibilities to take inventory of and manage the debtor's assets, verify claims, and create and file appropriate reports. The curator may terminate leases and executory contracts, and terminate employment contracts with notice of 45 days or more (arts. 38 & 39).

The court registrar manages a general register of actions in bankruptcy cases. The register is a public document to be available for anyone's inspection, free of charge (art. 20).

The court may annul gifts made by the debtor in appropriate circumstances and may void any of a series of defined fraudulent transfers (arts. 42 & 43).

The supervisory judge develops a reconciliation proposal, in consultation with an advisory committee of three creditors. The proposal may be accepted by majority vote at a meeting of creditors, where creditor votes are weighted in proportion to the amount of their claims.

In what may be the most pronounced setback from procedure under the 1998 law, the sale of tangible assets is first attempted by judicially supervised public auction. Privately arranged sales are permitted with the permission of the supervisory judge, but only if public auction fails to yield a fair result (art. 185).

There is no rehabilitation or reorganization option for the bankrupt debtor prior to liquidation.

Implementing Institutions

Commercial Court. The commercial court is a new institution that holds bankruptcy and IP cases in its portfolio. The commercial court is organized within the district court system. Judges on the commercial court are selected from the district court bench. Length of service is apparently the most salient qualification for selection. In conformance with the civil law tradition, judges may not be chosen from the ranks of practitioners.

Any improvement in the administration of bankruptcy law will require the cooperation of the commercial court. The court has ties with the international and bilateral lenders and aid agencies, and may be willing to entertain incremental measures that may yield ample benefits in return.

Supervisory Judge. The supervisory judge is appointed upon the filing of a petition with the commercial court. The supervisory judge has responsibility to oversee the curator's management of liquidation of assets. The supervisory judge also presides over creditor meetings.

Creditors perceive supervisory judges as in need of further educational opportunities and management tools. Continuing education opportunities are not widely and routinely available. Moreover, judges may rotate in and out of the district court, interfering with the development of expertise. Creditors have reported a lack of attention to their views by supervisory judges at creditor meetings and in their complaints about the behavior of curators.

Curator. The curator serves as the administrator of the bankruptcy estate. An effective curator must have knowledge of good business management and financial practices at the outset. Familiarity with the business of the debtor is also of high importance. In addition to fulfilling administrative requirements of the bankruptcy law, the curator may be required to operate the debtor's business, conserve business resources, mediate disputes, and dispose of assets or the business as a whole.

The office of the curator was established by the 1998 amendments and is continued under the 2004 law. Due in part to the high skill requirements, the supply of competent curators was and remains small. Donor-sponsored training programs have increased competencies in recent years, though severe challenges remain in developing a strong corps of curator talent. Creditors continue to complain that curators are insufficiently qualified. Apparently most curators have legal training at Indonesian law schools, but they are not trained in accounting or business management. Creditors also observe that curators often are not sufficiently motivated to discover the debtor's assets with sufficient energy, leaving debts unpaid that might otherwise have been satisfied. Worse are the complaints that curators use their position improperly to the advantage of some creditors over others.

The **Indonesia Curator and Administrator Association (AKPI)** was established recently to regulate and develop a corps of curators. AKPI has published guidelines for curators and for the preparation of required curator reports. Private perceptions are that compliance with AKPI regulations and guidelines is weak. Apparently, required curator reports are not prepared in a number of bankruptcy cases. Some judges may accept oral reports. Where reports are prepared, creditors have complained that they are disadvantaged by the sharing of reports with other creditors. More commonly, creditors find they cannot get access to information from the curator in any form whatsoever.

The bankruptcy law limits the number of cases that may be managed by a curator at any given time. It is reported that some curators routinely exceed the limit. The problem of a limited pool of curators is compounded by recurring appointments of the same individuals as curators, even when statutory maximums are not exceeded.

Supporting Institutions

Public execution offices. The bankruptcy law's preferred method of disposition of debtor assets is through the services of the public execution offices, supervised by the judiciary. The policy rationale is that public auction is more transparent than a private sale. The reverse may be closer to the truth, however, when bureaucratic procedures, market-distorting conditions, and rent-seeking checkpoints are taken into account. Private sale may be authorized if the curator persuades the supervisory judge that public auction fail to offer an acceptable result.

Prior to 2004, the curator had the option of public or private auction in most circumstances. Creditors prefer a resort to private sale, not to harm the debtor but to satisfy a higher portion of the claim.

Public registries. Discovering and verifying the debtor's assets is made more efficient when the curator has access to registries and other public records systems. Indonesian registries frequently complicate the curator's job. For example, land registries and the fiduciary guarantee registry should be valuable sources of information. Unfortunately, operators of these registries are unlikely to allow public inspection of their files. The availability of information appears to be higher when a personal relationship exists between the curator and registry officials. The fiduciary guarantee registry maintains no indexes of its records. No searchable computer records are maintained and ledger entries are made only in chronological order. Any attempt to search for a debtor's name would require poring over volume after volume of date-ordered records, if one were permitted to try (search requests must go through the minister's director general and applications must be supported by substantial documentation). Ownership registries for autos, aircraft, ships, and other valuable goods are equally opaque.

Professional associations. The Law Commission and Parliamentary commissions consult professional and trade associations as legal reform proposals are drafted. However, the associations appear to be less involved in monitoring implementation of new law.

Social Dynamics

International lenders and donors were active in supporting bankruptcy law reform in 1998 and 2004. There has been follow-up work as well, notably in assistance to the newly established commercial courts. There is a need for ongoing programs for development and maintenance of curator talent and judicial skills.

The executive branch and parliamentary commissions have separate sets of well-developed machinery for generating legislative proposals with ample professional assistance. Stakeholders in the government and private sector are routinely consulted in developing legislative proposals. Vetting processes extend throughout the nation when needed. However, there appears not to b substantial and routine monitoring or evaluation of major legislative initiatives, such as bankruptcy law, after the initiatives are enacted.

Private sector economic actors have low confidence in the judiciary in general. Modern bankruptcy law and the commercial courts are still new, and in the near term confidence in them cannot be expected to outstrip the generally low confidence level in broader institutions, absent significant efforts to upgrade levels of professionalism and institutional capacity.

Recommendations

- **Improve the recordkeeping system, including post-bankruptcy events**. The most fundamental, tangible, and non-controversial improvement would be reform of the bankruptcy recordkeeping system. The end result would be a system where documents submitted to the supervisory judge are collected and logged in a typical case file/docket sheet recordkeeping system. With the introduction of minimal new technology, this could allow creditors to scan and monitor case files via the internet.
- **Develop a benchbook that standardizes and simplifies decision-making.** A bankruptcy benchbook would promote recordkeeping where currently there is little or none, and facilitate quicker and better decision-making. The benchbook would contain an inventory of every possible decision a judge might face during a bankruptcy proceeding. For each possible decision, the benchbook should contain an analytical framework for making the decision and a form to help the judge create a paper record.
- **Engage an NGO to conduct a study on Pauline actions, inter-agency cooperation, and the use of auctions in bankruptcy**. A Pauline action is the method by which the court may order the reversal of a past transaction of a bankruptcy debtor that is harmful to creditors. Inter-agency cooperation is necessary to locate assets and encourage the debtor to cooperate. Auctions are the means by which a curator assures himself, the court, and the creditors that sales of assets of a bankruptcy debtor approximate their market value.
- **Build a dialogue between the commercial court and creditors; encourage creditors to use bankruptcy law.** Court and curator performance will improve if creditors are better able to shoulder more of the burden. Creditors can do better to monitor and police the system. Under ideal conditions, the creditors have access to records, take part in decisions, and can complain when things go wrong. Under current conditions, few creditors put in the effort.
- **Courts must recognize the role that creditors play and enter into a policy dialogue on how creditors can be better protected through the process.** This could be done by sponsoring a series of workshops or dialogue sessions between judges and creditors. A manual on how creditors can protect their rights in bankruptcy would also be helpful.

COMPETITION LAW AND POLICY

Introduction

An effective competition law is an important tool for achieving and maintaining good economic performance, including enhancing efficiencies and consumer welfare. Indonesia's first competition law, Law Number 5 of 1999 Concerning Prohibition of Monopolistic Practices and Unfair Business Competition ("Law No. 5" or "the Law"), was enacted on March 5, 1999, and took effect one year later. The Commission for the Supervision of Business Competition ("the KPPU"[51] or "the Commission") was established immediately after the passage of the Law, and the KPPU's first commissioners were appointed on June 7, 2000. In the seven years since, the KPPU has investigated more than 600 complaints of alleged unfair business competition (resulting in more than 75 case decisions) and issued more than 50 policy recommendations to the government advocating the adoption of competition-based policies across various economic sectors.

These efforts represent an important example for the region, as various other countries – including Cambodia and Philippines – are still in the preliminary stages of questioning whether and how to draft and implement a competition law. Notwithstanding Indonesia's important efforts, a genuine competition culture has been slow to take root. This may largely be due to the fact that stakeholders do not fully understand the objective of competition law and policy. Many believe its purpose is to protect individual business actors -- particularly small and medium-size businesses – even at the expense of enhanced efficiency and consumer welfare. In addition, many stakeholders believe that Law No. 5 has many ambiguities and needs clarification through additional guidelines and amendments. Stakeholders' experiences with the KPPU, Indonesia's first independent agency with quasi-judicial authority, also present serious concerns about the level of fairness and due process in KPPU investigations and hearings and, more generally, its capacity to conduct a proper economics-based antitrust investigation.

However, stakeholders do credit the KPPU with some successes. Most notably, the KPPU has been extremely successful in attacking a large number of bid-rigging cartels – these represent about 50 percent to 60 percent of the Commission's cases. In addition, the KPPU has experienced a more limited degree of success advocating that other government agencies adopt competition-based policies.

Legal Framework

Stakeholders consistently expressed three main complaints with the content of Law No. 5. First, there is confusion as to the stated purpose of the Law. Second, there are many ambiguities within the substantive provisions of the Law. Third, the Law and the KPPU's internal regulations raise serious fairness and due process concerns during investigations and hearings. Stakeholders believe that these problems have contributed to the lack of a genuine competition culture in Indonesia.

[51] KPPU is the Indonesia acronym for Komisi Pengawas Persaingan Usaha.

The lack of clarity in the stated purpose of the law. Stakeholders believe that the stated purpose of the competition law is loosely written and subject to differing and possibly conflicting interpretations. Specifically, the purposes of the Law are set forth in Article 3: safeguarding the interests of the public and improving national economic efficiency; ensuring equal business opportunities for small-, medium-, and large-scale businesses; preventing monopolistic practices and unfair business competition; and creating effectiveness and efficiency in business activities. Many stakeholders, including large and multinational business actors, academics and economists, believe the overriding purpose of Law No. 5 is to protect and promote business activity that enhances efficiency and consumer welfare. Other stakeholders, principally small business actors that are exempt from the Law under Article 50h, believe the Law is primarily intended to protect individual business actors, particularly small and medium-sized businesses. These stakeholders claim that this latter interpretation is consistent with Indonesian business culture, which has been one where businesses work together and cooperate rather than compete. The KPPU has not issued any guidelines explaining the principal purpose of the Law or how the various purposes stated in Article 3 should be evaluated and weighed in any particular case. However, stakeholders believe that the KPPU's written case decisions largely support the view that the Law's primary purpose is to protect individual business actors, even at the expense of enhanced efficiency and consumer welfare.

The *Indomarco* case[52] is the principal KPPU decision cited by many stakeholders for the proposition that Law No. 5 is aimed at protecting individual business actors. In *Indomarco*, a large-scale convenience store chain (operating under the name Indomaret) expanded into nontraditional areas offering a wider selection of products, more convenient store hours, and lower (but not predatory) prices than the existing small-scale stores. Many small-scale stores that lost revenue or were forced to close because they could not match Inomaret's lower prices and greater services complained to the KPPU. After an investigation, the KPPU concluded that Indomaret, by expanding into nontraditional areas, did "not observe the principal balance of economic democracy in promoting healthy competition between the interests of business actors and the public interest," thereby harming existing businesses that could not compete with the prices and services of Inodomaret. The KPPU did not find that Indomaret violated any substantive provisions of Law No. 5 (*e.g.*, that it abused its dominant position); rather, it determined that Indomaret violated the purposes of the Law stated in Articles 2 and 3. The *Indomarco* decision is thus seen as placing the protection of individual business actors above enhanced efficiency and consumer welfare.

Although *Indomarco* was an early decision, stakeholders believe that several subsequent decisions have continued to support the view that the purpose of the Law is to protect individual competitors, with little or no consideration of whether the challenged business activity enhances efficiencies and consumer welfare. A very recent example cited for this proposition is *Yamaha.*[53] Yamaha apparently made an independent business decision not to allow a particular dealer to distribute Yamaha products. The dealer complained to the KPPU, which decided that Yamaha had to supply products to the dealer, even though there was no evidence that Yamaha's refusal to

[52] Case Decision No: 03/KPPU-L-I/2000, Retail PT. Indomarco Prismatama (July 4, 2001).

[53] Case Decision No. 04/KPPU-L/2006, Yamaha's Motorcycle Distribution System in South Sulawesi (November 1, 2006).

supply had resulted in harm to competition rather than harm to the individual competitor. Consequently, stakeholders believe that the principal, if not sole, purpose of Law No. 5 is the protection of individual business actors. It is unclear whether evidence of enhanced efficiencies, consumer welfare, or business justifications will be given much, if any, weight by the KPPU.[54]

The lack of clarity in the law's substantive provisions and exemptions. Articles 4 through 28 of Law No. 5 cover a full range of acts and practices deemed anticompetitive in most other competition jurisdictions, including but not limited to price fixing, bid rigging, market allocation, group boycotts, certain vertical agreements (e.g., price discrimination, minimum resale price maintenance, tying arrangements, and exclusive dealing), monopolies and monopsonies, certain exclusionary conduct (e.g., discriminatory practices and predatory pricing), abuse of dominance, and anticompetitive mergers and acquisitions. Although the Law's prohibitions parallel those of other jurisdictions, competition law and policy is new to Indonesia and, consequently, many stakeholders have expressed the view that further clarification and guidance is needed. As discussed above, a significant part of this need can be attributed to the unclear or conflicting objectives of the Law, but some of it is due to the absence of substantive guidelines.

Under Article 35f, one of the KPPU's duties is to "prepare guidelines and/or publications relating to the Law." However, during the first seven years the KPPU issued only one substantive guideline (collusive bidding)[55] and a few technical guidelines concerning internal case handing procedures.[56] Most recently, the KPPU has been working with a panel of "invited experts" from the private sector and academia to draft guidelines on various substantive provisions in need of clarification. The KPPU expects to issue additional guidelines for comment by the end of 2007. The KPPU is also conducting a study to consider possible amendments to the Law; it anticipates having a draft recommendation this year. Nonetheless, stakeholders believe that the KPPU has been too slow to provide needed clarification and guidance, and must take appropriate measures to be more responsive in the future.

Stakeholders believe that many substantive provisions of the Law are unclear and in need of explanation or elaboration through additional written guidelines and publications, Commissioners' speeches, and written case decisions. For example, under Article 19 stakeholders are uncertain as to whether firms in a concentrated market have an absolute duty to deal with competitors (and potential competitors), or whether there must also be a showing that the refusal to deal will result in some harm to competition.[57] Similarly, stakeholders are unclear as to the business practices that the KPPU will consider to be "discriminatory practices" prohibited under Article 19d. More generally, stakeholders do not understand how the KPPU defines a relevant market for purposes of assessing market shares and conducting a competitive

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[54] The two decisions most frequently noted by stakeholders as examples of where the KPPU failed to give adequate consideration to significant efficiencies or business justifications are Pelindo I Belawan Branch and PT. Musim Mas (Case Decision No. 01/KPPU-L/2004) and KAP Hadi Susanto, firm member of Pricewaterhouse Coopers (Case Decision No. 08/KPPU-L/2003).

[55] Guideline for Article 22 of Law No. 5 of 1999.

[56] *E.g.*, KPPU Decree No. 1 of 2006.

[57] Stakeholders claim this was inadequately addressed by the KPPU in *KAP Hadi Susanto* (Case Decision No. 08/KPPU-L/2003 (June 14, 2004)), wherein KAP Hadi, a member of Pricewaterhouse Coopers, was found to have violated Article 19 by refusing to allow another accounting firm to use the results of an earlier KAP Hadi.

effects analysis. This is of particular concern to stakeholders because some provisions of the Law (*e.g.*, Article 27 on Cross Ownership) declare certain acts illegal *per se* once a market share threshold is satisfied.[58] Consequently, proper market definition becomes essential. Similarly, stakeholders also request guidance on how the KPPU will conduct a competitive effects analysis, including the measuring and weighing of efficiencies, for business practices that are subject to a rule of reason analysis. Finally, while mergers and acquisitions can often produce substantial efficiencies, some transactions may create or enhance market power and harm the competitive process. This section of the Law has not been enforced because the required government regulations concerning the prohibition of mergers and acquisitions have not been issued.

Stakeholders also expressed confusion and uncertainty about the exemptions contained in Article 50 of Law No. 5. Nearly every stakeholder interviewed consistently questioned the exemption for agreements relating to intellectual property rights (IPRs) (Article 50b) and the exemption for business actors of the small-scale group (Article 50h). Multinational business actors, in particular, would like clarification on the scope IPRs and would like to see the exemption harmonized with other jurisdictions. Most believe that it is seen as an absolute exemption and that anything remotely involving IPRs is immune from challenge under Law No. 5. Stakeholders believe that the small business actor exemption is also absolute, thus allowing these business actors to engage in otherwise anticompetitive behavior, including horizontal price fixing and market allocation. Business actors and academics believe that the small business exemption is overly broad.

The lack of due process. The third principal area of concern relating to the legal framework of Law No. 5 is the KPPU's case-handling procedures, particularly those related to the principle of fairness and due process. Law No. 5 establishes very tight time periods for KPPU investigations. Preliminary investigations must be completed within 30 days after receipt of the complaint.[59] If the KPPU determines that further investigation is required, the follow-up investigations must be completed within 60 days,[60] but may be extended by not more than 30 days.[61] Aware that these time periods are often inadequate to conduct a proper investigation, the KPPU recently issued internal regulations that, among other things, extend the time period for investigations.[62]

Stakeholders believe that there is a serious lack of due process in the KPPU's case-handling procedures.

[58] A related point raised by some stakeholders, including economists and academics, is whether market shares should be measured only as a percentage of sales (purchases), as provided for in Article 1.13, or whether other measures may more accurately reflect market conditions in some circumstances.

[59] Article 39(1).

[60] Article 43(1).

[61] Article 43(2).

[62] *See* KPPU Decree No. 1 of 2006, which adds two stages prior to the preliminary investigation under Article 39(a). During Stage 1, staff is allowed 60 days (subject to an additional 30 day extension) to conduct an investigation. During Stage 2, a different team of staff members conducts a 30 day investigation. Compulsory process is not available during either stage. After the Stage 2 investigation, if necessary, the matter is converted to a preliminary investigation under Article 39.

Notwithstanding the additional time for investigation, stakeholders believe that there is a serious lack of due process in the KPPU's case-handling procedures for at least two reasons. First, despite the additional time for investigation, the target of the investigation often does not learn about the investigation until it is almost complete, or is otherwise given little notice and time to develop a defense and challenge the KPPU's findings. Stakeholders would like to see the case-handling procedures amended to provide more notice and opportunity to respond. Second, and somewhat related, is the fact that the target of the investigation is not allowed to cross-examine the KPPU's witnesses. Under Article 38(3), the identity of the complaining party must be kept confidential. In addition, the identity of other witnesses can be withheld under the KPPU internal regulations.[63] Consequently, the record developed before the KPPU is not the product of an adversarial proceeding in which the target of the investigation can challenge the reliability and possible biases of the KPPU's witnesses and other evidence. Moreover, if the KPPU's decision is appealed to the District Court, the review is limited to the record developed by the KPPU. No additional evidence is allowed. Therefore stakeholders believe that the KPPU's case-handling procedures should be amended to address these serious due process concerns.

Implementing Institutions

The KPPU. The KPPU has three principal mandates: investigating possible violations of Law No. 5;[64] providing competition policy recommendations to the government;[65] and issuing guidelines and publications regarding the Law.[66] The KPPU may investigate alleged violations of the Law either as a result of public complaints or on its own initiative. From June 2000 through April 2006, the KPPU received 428 complaints and issued 59 written case decisions.[67] The number of complaints and cases has increased each year since 2000. The annual breakdown of complaints and cases is summarized in the table on the following page.

As of May 2006, 27 cases resulted in a finding of a law violation and seven cases resulted in a finding of no law violation. An additional 14 cases were terminated during the case examination process due to the lack of evidence. The remaining cases were ongoing. More than 50 percent of the KPPU's cases have been dominated by alleged collusive tendering (Article 22). As of May 2006, 15 KPPU decisions were appealed to the district court. Twelve of those appeals had been decided, but only three in favor of the KPPU. While the KPPU's enforcement has been described as effective in terms of the number of cases, stakeholders believe that the emphasis on Article 22 bid rigging cases has been at the expense of adequate enforcement of other substantive areas of the Law, particularly merger enforcement. However, with the KPPU's orientation toward protecting small business with little or no regard to possible efficiencies, increased enforcement in the area of mergers and acquisitions may be counterproductive. Stakeholders believe that with limited resources the KPPU must exercise more discretion in its case selection. In particular,

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[63] *See* KPPU Decree No. 1 of 2006.

[64] Articles 35a-c.

[65] Article 35e.

[66] Article 35f.

[67] Data for the period ending April 30, 2006 is used because it is the last date for which published data is available. *See* Annual Report on Competition Policy Developments in Indonesia, available at http://www.oecd.org/dataoecd/54/37/37008699.pdf. The KPPU estimates that as of April 2007, it has received more than 600 complaints and issued about 75 written decisions.

stakeholders note that several of the Article 22 cases involved purely vertical agreements, mainly corruption in government bids that could (or perhaps more properly should) be handled by the Anti-Corruption Commission, thus freeing up the KPPU's resources to bring cases in other areas.

Public Complaints and Cases, June 2000 through April 2006		
Year	Complaints	Cases
2000	7	2
2001	31	5
2002	49	8
2003	57	9
2004	71	9
2005	182	22
2006 (as of May)	31	4

In the area of competition advocacy, as of April 2006, the KPPU had submitted more than 50 policy recommendations to the government. The KPPU's efforts to promote the adoption of competition-based policies across various economic sectors has had mixed results. The government agencies that have adopted the competition policy recommendations of the KPPU, such as telecommunications and oil/gas, have seen significant improvement in their economic sectors, while many of the other economic sectors remain largely concentrated, less competitive, and less efficient. The most frequently cited example of the successful implementation of competition policy is in the airline industry, where the KPPU advised the government not to establish a price floor, but to allow prices to be set by market forces. Since adoption of the KPPU's recommendation, airline prices have fallen significantly.

With respect to its third mandate, the issuing of guidelines and publications regarding the Law, the KPPU, as discussed earlier, has issued a few technical guidelines concerning case handling procedures, and only one guideline concerning the substantive provisions of the Law. Additional guidelines are expected to be released in draft form later this year.

The KPPU's institutional capacity. The KPPU's institutional capacity is maturing, but stakeholders believe that there is room for improvement. The KPPU has opened regional offices in five other cities and increased its staff to about 200, adding 77 new staff members in the last year, in large part due to significant staff turnover. Its professional staff is evenly split between lawyers and economists. The KPPU has received substantial assistance and training from various visiting international experts and long-term resident advisors, including USAID, the Australian Agency for International Development (AUSAID), GTZ, the Japanese Fair Trade Commission (JFTC), and the World Bank, although the amount of assistance has decreased over the last two years. Notwithstanding the support of various foreign donors and the investigation of more than 600 complaints (including 75 resulting in full case decisions), stakeholders continue to view the KPPU's commissioners and staff as lacking the capacity to conduct a solid economics-based antitrust analysis.

Stakeholders believe that this lack of capacity is reflected in the KPPU's written decisions. While stakeholders believe that the Commission's decisions have shown some improvement over the years – most now list the elements of the violation – they contain little or none of the economic analysis that is common in the competition decisions issued in other jurisdictions. Most stakeholders view the KPPU's decisions as a mere mechanical application of the law, stating facts, the elements of the violation, and the conclusions, without any underlying market analysis. Generally, the decisions lack an explanation as to why the challenged business practice is (or is not) harmful to competition. Stakeholders, most notably economists and academics, view this as a missed opportunity for the KPPU to educate business, government, and the public about competition law and policy. Even where the challenged business practice is illegal *per se*, these stakeholders believe it would be beneficial for the KPPU to explain why the practice is deemed illegal.

Stakeholders do not have a "quick fix" for the KPPU's capacity problem, but many did suggest that the addition of a chief economist, specifically one trained in industrial economics and antitrust analysis, among the Commission's several directorates would be a step in the right direction. The new directorate would be staffed with economists whose primary responsibility would be to provide economics-based analysis in every investigation. Although the KPPU's professional staff includes several economists, stakeholders believe that the economists are not being used optimally for their economics knowledge, but more as investigators assigned to assist the lawyers in the investigations. Stakeholders also suggest that the KPPU could more readily develop expertise by having its staff specialize either by area of law (e.g., mergers, price fixing, abuse of dominance) or by industry sector, a practice that is common among competition agencies in other jurisdictions.

There is also concern among stakeholders about the KPPU's ability to handle the growing number of complaints and cases (see the table on the previous page). Some stakeholders believe that the KPPU should exercise prosecutorial discretion in its case selection rather than investigating every complaint it receives. At the same time, it is unclear whether the courts will entertain private rights of action under Law No. 5.[68] Until there is a clear private right of action, stakeholders believe that it may appear unfair to condition a private party's right to obtain redress on the KPPU's exercise of prosecutorial discretion.

The courts. The KPPU was Indonesia's first independent agency with broad authority, including adjudication.[69] The KPPU's decisions can be appealed to the District Courts,[70] and the District Courts' decisions are subject to further review by the Supreme Court.[71] Initially, the KPPU encountered substantial resistance with respect to its authority, including the Administrative

[68] Even absent a specific private right of action under Law No. 5, Article 52(1) provides that private actions for anticompetitive conduct can be brought under various other laws, to the extent they are not contradicted or superseded by Law No. 5. *See, e.g*., Criminal Code of 1945, Article 382 (concerning fraud and unfair business practices) and Civil Code of 1945, Article 1365 (concerning the recovery of damages by private parties for violations of the law).

[69] Article 30(2) declares that he KPPU "shall be an independent institution free from the Government's and other parties' influence and authority."

[70] Article 45(1).

[71] Article 45(3).

Court invalidating the KPPU's decision in *Indomobile*,[72] and deciding that the KPPU had no jurisdiction over the matter. Subsequently, at the urging of many stakeholders, the Supreme Court issued Perma No. 1 of 2003, providing clarification and guidance on, among other things, the KPPUs role in investigating and deciding competition cases, and the standard of review on appeal. But Perma No. 1 of 2003 left many unanswered questions, so in July 2005, the Supreme Court issued Regulation No. 3 of 2005, which: (a) requires that appealed KPPU decisions be reviewed by a panel of judges trained in or having knowledge of competition law; (b) limits the District Court's review of the evidence before the KPPU and does not allow the introduction of new evidence; and (c) allows the District Court to remand the case to the KPPU with clear instructions on the issues to be reexamined.

The courts have received some training in economics and competition law, but most of the appeals have been decided on procedural and other issues that did not require the use of economic analysis. Nonetheless, most stakeholders believe that the courts are no better equipped than the KPPU to conduct a sound economic-based analysis of competition cases.

Supporting Institutions

The **President, various ministries, and other high-ranking governmental officials** generally support the KPPU and its competition policy mandate. The KPPU regularly meets with various ministries, including the Ministry of Finance and the Ministry of Trade, to discuss competition law and policy, and, as noted earlier, it has submitted more than 50 policy recommendations to the government advocating the adoption of competition-based policies across various economic sectors. Privatization has also been occurring across some industrial sectors, although at a much slower rate than originally anticipated at the time of reform. In addition, substantial barriers to entry and expansion continue to exist in the form of government regulations.

Many of the professional associations and NGOs that emerged following the enactment the competition law have since dissolved or otherwise taken a less active role in the development of competition law in Indonesia. Similarly, various foreign donors who supplied strong support for competition reform through various training programs and the placement of long-term legal and economic advisors at the KPPU have since left.

Several **professional associations and other NGOs** emerged in the competition field immediately after the passage of Law No. 5, including, but not limited to, the Indonesia Antitrust Lawyers Association, Partnership for Business Competition, Monopoly Watch, Center for Law and Policy, and the Institute for Business Competition and Policy Studies. These associations actively monitored developments in the area of competition law and policy in Indonesia, regularly interacted with the KPPU on issues related to the Law and competition policy in general, socialized the Law through training and education programs, and issued written comments on some KPPU decisions. However, many of these associations have since been dissolved or become inactive due to the lack of funding or, some claim, frustration with the KPPU and the implementation of competition policy in Indonesia. According to many of these associations, their ability to

[72] Case Decision No: 03/KPPU-I/2002 Tender PT. Indomobil Sukses International (May 30, 2002).

conduct effective training and education programs was hampered by the lack of clarity in the objectives and substantive provisions of the Law. However, more **law schools** and **business schools** are providing support by offering courses and programs on competition-related issues.

Social Dynamics

Most stakeholders believe that a genuine culture of competition has been slow to take root in Indonesia. Many are skeptical of the KPPU's capacity to implement competition policy and, more broadly, the government's commitment to competition policy in general. Most government officials are perceived as being unfamiliar with the goal of competition policy reform in Indonesia, and only a few high-level officials are considered strong advocates for improved competition policy. As noted earlier, many of the professional associations and NGOs that emerged following the enactment the Law have since dissolved or taken a less active role in the development of competition law in Indonesia. Similarly, many foreign donors who supplied strong support for competition reform through various training programs and the placement of long-term legal and economic advisors at the KPPU have since left. Although privatization has occurred, it has been at a much slower pace than had been anticipated at the time of reform. The KPPU's efforts to encourage other governmental agencies to adopt competition-based policies across various economic sectors has had mixed results.

At the same time, some KPPU Commissioners have recognized the role that competition can play in promoting not only Indonesia's development and competitiveness, but also in the entire Southeast Asia region. These Commissioners have pushed the ASEAN Secretariat and Indonesia's representatives to ASEAN to begin discussing how ASEAN will ensure open competition across borders when the economies of the member countries are more integrated. The progress in putting competition on the agenda of discussion items at ASEAN has been slow because within ASEAN some members are not as committed to allowing open competition. Whatever progress there has been is a result of Indonesia's initiative.

The government generally is seen as providing for meaningful private sector participation in the area of competition law and policy reform, but most believe that it can do more. Stakeholders view the procedural guidelines and regulations issued by the KPPU and the Supreme Court as helpful, but believe more clarity is needed concerning the objectives and substantive provisions of the Law. In this regard, the KPPU continues to work with stakeholders on competition policy issues, including working with a panel of "invited experts" to draft guidelines on various substantive provisions of Law No. 5 expected be issued this year. Stakeholders will be given an opportunity to comment on the draft guidelines before they become effective. Draft amendments to Law No. 5 are anticipated later this year, and stakeholders will be given an opportunity to comment before the amendments become final.

Recommendations

The KPPU should consider:

- Taking a leadership role in educating stakeholders about the principal objectives of competition law and policy in Indonesia through the issuance of guidelines, publications, speeches, and written decisions.

- Addressing the inherent ambiguities in the substantive provisions of the Law No. 5, and responding to stakeholders' future needs in a timely manner. In this regard, the KPPU should consider establishing a more formal mechanism for the receipt of regular input from and providing feedback to stakeholders.
- Modifying its case-handling procedures to provide a higher degree of due process safeguards by providing the target of the investigation sufficient notice and opportunity to develop a complete evidentiary record.
- Developing the capacity to conduct economic-based investigations and analysis, which should be openly reflected in its internal procedures and written case decisions. The KPPU should consider establishing an Economics Directorate consisting of a PhD. economist, specifically trained in industrial economics and antitrust analysis, and a staff of economists whose primary responsibility is to provide economics-based analysis. Additionally, the KPPU might wish to consider having its staff specialize by area of law or industry.
- Exercising prosecutorial discretion in its case selection.

COMMERCIAL DISPUTE RESOLUTION

Introduction

Indonesia's environment of free-wheeling and often cutthroat capitalism provides a wide variety of techniques for commercial dispute resolution. These run the gamut from time-consuming lawsuits to highly sophisticated arbitrations and mediations to crude intimidation.

The Indonesian government heavily regulates foreign investment, which normally takes the form of an equity joint venture with an Indonesian business partner. Potential investors are often engaged in commercial disputes with joint venture partners, employees, local suppliers or contractors, or government agencies. The key to successful resolution of these disputes often lies with influence with a powerful family or general. Nevertheless, there are a few bright spots of effective and transparent dispute resolution processes.

Commercial dispute resolution in Indonesia runs the gamut from time-consuming lawsuits to highly sophisticated arbitrations and mediations to crude intimidation.

One such bright spot involved the Women's Legal Aid Society and their efforts to sue the government in two class actions involving capricious enforcement of local regulations for street vendors and kiosk owners. They did not win the lawsuits, but public awareness of the problems caused local regulations to become more uniform and fairly enforced. The Legal Aid Society did prevail in a third class action for flood damage that was a direct result of incompetent and negligent city planning. There is now a belief that people can sue the government and occasionally receive a fair ruling, particularly in the economic sector.

Generally speaking, people and businesses who are fortunate enough to have connections with the powerful elite avoid the courts. In disputes involving large sums, arbitration in Singapore is often preferred (even by the Indonesian government) as a formal settlement venue.

In smaller cases, contract interpretation and enforcement is capricious and only a few experienced judges in Jakarta are regarded as honest and competent. Corruption and racketeering are common. Another overarching theme is that reform efforts are disorganized and short-lived, and there is often no way to determine who or what agency is leading the reform effort. While there is growing public awareness of the importance of reliable courts and dispute resolution processes, the entrenchment of people at every level of society in the present system will be a formidable obstacle to reform.

Legal Framework

The legal framework for commercial litigation in Indonesia is established by the Code of Civil Procedure, various implementing regulations, and directives from the Supreme Court. A directive from the Chief Justice of the Supreme Court reminds and instructs judges that the law requires them to engage in court-based mediation as part of their handling of cases. Some of the District Court judges, especially in Bandung, have wholeheartedly embraced this directive and are slowly changing the culture of litigation. Nevertheless, the obstacles to early settlement of cases are significant. Often the real stakeholder will not attend the conferences but rather send representatives.

Lawyers often see mediation as a threat to their fees, which typically depend on a long series of piecemeal hearings. For example, a trial that might last one day in other judicial systems may take months with separate hearings held for such events as direct examination of a witness, cross examination, final argument for only one side, and a decisional conference. Judges often do not see a responsibility to manage a case and will pay more deference than is due to one side's pacing of the litigation. Bribes for moving a case along ("speed money") may also be involved.

Lawyers often see mediation as a threat to their fees, which typically depend on a long series of piecemeal hearings.

The infrastructure of court jurisdictions is clearly defined. District Courts, High Courts, and the Supreme Courts are the courts of general jurisdiction, with the lower levels hearing cases *de novo* on the basis of facts and law. In theory, appeals to the Supreme Court should be limited to questions of law, but in practice the Supreme Court does not limit cases in this way. Facts are heard *de novo* and appeals are freely granted at both appellate levels. There is also no incentive to dismiss frivolous cases.

This phenomenon of automatic appeal can eliminate accountability. Judges at the lower levels are insulated from responsibility for poor decisions because the decision, once appealed, has no binding power. And because the Supreme Court exercises no discretion in selecting cases, much of the current backlog in the courts of general jurisdiction can be explained by the failure to summarily dismiss frivolous suits at lower levels.

The Commercial Court was established in 1998 with a bankruptcy and (from 2003) an IP jurisdiction. The Commercial Court was busy immediately following the economic crisis, but its docket has dwindled and it is reported that some of the Commercial Court judges (especially in the provinces) are idle to the point of assisting with the domestic relations dockets. For tax disputes, there is a Tax Court located within the Ministry of Finance.

An Anti-Corruption Court exists and is a focus of reform in Indonesia today. The matters it considers usually involve money laundering, bribery, and other forms of official corruption. The court has had some success in keeping corruption in the news and as a focus of reform efforts. However, on December 19, 2006 the Indonesian Constitutional Court declared Article 53 of Law No. 30/2002, which established the Anti-Corruption Court, unconstitutional. Despite this, the Anti-Corruption Court was not disbanded. Instead, the Indonesian government and Parliament were given a three-year period within which to draft and adopt new legislation to cure the constitutional defects. A USAID-supported Task Force prepared the initial draft law, which the formal government drafting committee accepted as the draft for further discussion.

At this time, Indonesia's President favors re-invigorating the Judicial Commission to oversee the courts. The consolidation of court operations under the Supreme Court has caused concern among the ruling elite that the courts are now too independent and too powerful.

Arbitration has long been recognized in law as a procedure separate from litigation under Law No. 30 of 1999 concerning Arbitration and Alternative Dispute Settlement. Indonesia is a signatory to the New York Convention on the Recognition of Foreign Arbitral Awards. Foreign arbitral awards may be enforced in Indonesia if they are not contrary to public policy.

In practice, there is a tendency in some cases for the court to reexamine a case that underwent arbitration and refuse enforcement of the award. However, by all accounts, a growing number of domestic and foreign arbitral awards are being enforced.

Implementing Institutions

Court organization. The jurisdictional boundaries of courts in Indonesia are vestiges of Indonesia's long colonial history and are clearly defined. The Ministry of Justice (MOJ, and now called the **Ministry of Justice and Human Rights**) had regulated court budgets and personnel and the Supreme Court was responsible for procedural operations of the general courts and the Commercial Court. In addition, the **National Development Agency** (BAPPENAS) in involved in planning and reform and houses a steering committee that includes a subcommittee responsible for steering the Commercial Court.

In 2004 the government proposed to significantly change the regulation of court organization. To comply with the five-year blueprint envisioned by the 1999 Law on Judicial Power, the Ministry of Justice transferred its budgetary and human resource powers to the **Supreme Court**. One Supreme Court justice described the implementation of this blueprint as "two-thirds complete." Within this scheme, the major responsibility for legislative drafting rests with the MOJ or with the ministry responsible for a particular subject matter. Oversight of the legislative process will remain with the Cabinet Secretariat. In parallel with this, a law was enacted to establish a **judicial commission** responsible for appointment of judges and, to some extent, supervision of the Supreme Court.

Court operations. As stated above, most commercial disputes in Indonesia are resolved outside the courts. As much as possible, foreign investors design their transactions to avoid contact with the Indonesian court system. No one is satisfied with the performance of the courts. Almost universal consensus exists among end users and outside observers that the courts are not an efficient, transparent, accountable, competent, or reliable venue for commercial dispute resolution.

Efficiency is undermined by the automatic right of appeal, which reopens the whole case at the next level, allowing lower level judges to evade responsibility for the quality of their work and allowing parties to present new, and sometimes previously concealed, evidence. The Supreme Court backlog of roughly 9,000 cases may be attributable to the judges' workload and their refusal to summarily dismiss frivolous or unsuitable appeals.

Transparency is not achievable because of the commonplace practice of attorneys bribing judges, court clerks, and other court staff. This phenomenon is even more pronounced in the provinces and was outlined in a 2005 UN study of corruption in two provinces. Appointment and rotation of judges are considered business opportunities. Judges who have endured low pay, low status, and difficult living conditions in the provinces or in the early years of their career regard a posting in Jakarta as an opportunity to take their turn as beneficiaries in a corrupt system.

Accountability is lacking because the courts are not organized on recognized public service principles. Neither work output nor quality is measured. In addition, there are too many judges appointed for the existing national workload. Judges' decisions are neither routinely published nor made available to the public. No transcripts of hearings are taken and hearing notes have been known to be altered. If you ask for a receipt for a court fee, you will be considered to have a "bad attitude."

Judges' competence to hear commercial cases is often questioned. Many donor-funded projects deliver judicial training, but many judges still do not possess the basic legal education, ability, or diligence to become familiar with modern commercial law.

Reliability is lacking in the courts because there is no system of binding precedent, even within the Supreme Court itself. Any decision, other than in the Constitutional Court, may be overturned subsequently by another court.

Much foreign donor funding has been directed at improving the efficiency and transparency of court operations not only within the Supreme Court and courts of general jurisdiction, but also in the establishment and operations of the commercial court. The results over the past decade have been mixed.

Alternative dispute resolution. The Indonesian National Arbitration Board (BANI) is a private-sector commercial arbitration organization. BANI now has an impressive roster of arbitrators (over 200) that include a number of the best of the retired judges in Jakarta. Their procedures and facilities are garnering a growing respect in the business community in Indonesia and abroad. Their expertise in arbitration and mediation is particularly sought after in smaller local cases. Other arbitration institutions have been established, such as the Indonesia Muamalah Arbitration Board (BAMUI) and the Indonesia Capital Market Arbitration Board. BAMUI is associated with one of the major *shariah* banks, Bank Muamalah, and is designed primarily to resolve disagreements about *shariah* banking and insurance transactions, mostly within the banks.

Formal mediation for commercial disputes involving insolvency in Indonesia to date has spawned the Jarkarta Initiative process to affect workouts of troubled companies as an alternative to processing bankruptcy disputes through the commercial court. The National Mediation Center also grew out of the economic crisis of the late 1990s and is a growing source of expertise in crisis management and mediation as well as debt restructuring.

Finally, a national Mediation Institute was founded in September 2003, with the objective of broadening the base of mediation services in Indonesia.

Creating viable commercial arbitration and mediation services in Indonesia is linked with solving the problems with the courts, where final responsibility for enforcing arbitral awards or mediation agreements lies.

Informal resolution of commercial disputes. As stated above, in Indonesia people seldom go to court if they can avoid it. Most business people prefer to resolve disputes through discussion, negotiation, and social pressure. However, considerable diversity exists in the norms governing disputes. Commercial custom can be found within *adat* or customary law. Like formal modern law, *adat* can also be subverted to serve the interests of powerful individuals in a community.

Some ethnic commercial communities (especially the Chinese) have a well-developed set of norms that do not require state intervention. Unfortunately, self-help in debt collection and intimidation is also a fairly common experience, especially in urban areas.

Supporting Institutions

Lawyers. There is only a rudimentary legal profession in the classic sense in Indonesia. Like judges, lawyers in Indonesia were deliberately undermined during the Suharto era. The new Advocates Law (No. 18/2003) identifies **eight bar associations** in Indonesia. These bar associations have been united, at least in principal. The general consensus is that bar associations are beginning to engage in meaningful training for their members, regulation of professional standards or ethical conduct, and *pro bono* activity such as advising government on desirable legal reforms. They are also now conducting the bar exam in an honest way so that people can no longer merely buy a law license.

The lack of meaningful professional organizations for lawyers has serious consequences. Until now, when lawyers lobbied for law reform or were consulted by government on law reform, they acted only in their individual capacity. In addition, some lawyers are also universally identified as the suppliers of bribes to judges and other government officials.

Although there have been improvements in the curriculum offered to law students, the character of **legal education** does not satisfy the needs of private practice in the commercial and noncommercial spheres.

Very little organizational pressure is applied to lawyers to require them to enhance their qualifications or knowledge at a time when legal issues globally are becoming highly complex.

To date, no effective professional ethics constrain lawyers, and no organizational norms channel ordinary lawyers toward public interest or *pro bono* work.

Lawyers are frequently principals in business activities, which this generates areas of conflict of interest. They are often not qualified to act as authoritative monitors of government and private sector conflicts of interest or breach of good government principles.

Arbitrators. Indonesia has a shortage of trained commercial arbitrators. Under current conditions, in large commercial disputes Indonesia does not provide arbitration services that compete effectively with Singapore, Malaysia, or Hong Kong.

Donors. The donor community endeavors to support the area of commercial dispute resolution in Indonesia. USAID has been particularly active in the area of court reform. The Indonesia Anti-Corruption and Commercial Court Enhancement Project seeks to improve the administrative practices of the commercial courts so that they will be a model for efficiency and honesty throughout the country, thereby contributing to increased public confidence generally.

Social Dynamics

Demand for reliable commercial dispute resolution, particularly through the courts, is very high among foreign legal professionals working in Indonesia and among top echelon Indonesian lawyers.

The government has signaled some support for the courts through the planned reorganization of agency responsibilities, but Parliament continues to under-fund the judiciary and ancillary services. Judicial training, for example, is held every three years instead of annually.

Foreign donors have identified the courts as a key target for funding following the 1997 crisis. The Supreme Court, with support from numerous donor agencies, has developed a blueprint for future development, which is being implemented.

Judicial training is held every three years instead of annually.

Many respondents have serious doubt that the court system has the capacity to effectively use this funding and whether the reorganization of the court system will bring dramatic improvements in the court system.

The use of Arbitration and mediation remain is low because of the lack of trained professionals to provide these services and because enforcement relies on having a functioning court system.

Recommendations

In the near term a few simple, inexpensive changes would provide a potentially dramatic speed up of reform.

- The courts should consider following Bandung's lead in utilizing court-annexed mediation.
- Support for training in arbitration and mediation skills could be greatly increased.
- An effort to ensure that foreign arbitration awards are strictly enforced should take place through training and better information provided to law students, lawyers, and judges.
- A mechanism for dismissing frivolous cases should be established at all levels.
- Judicial training should be increased, with an emphasis on updating judges' understanding of new laws and improved case management.

COURT ADMINISTRATION

Introduction

The lack of accessibility, transparency, accountability, and universal competence in the court system creates negative byproducts, diminishing the quality of life for everyone. Investors are looking carefully at Indonesia and its courts for signs of real and lasting economic health to take Indonesia into the future as a leader in Southeast Asia

Legal Framework

The Constitution and an assortment of other regulations regulate the Indonesian judicial system. The Supreme Court is the highest judicial institution in Indonesia, and it handles the organization, administration, and finances of the Courts of General Jurisdiction. The Religious Court was excluded from this supervision but is expected to eventually be under the supervision of the Supreme Court.

The Supreme Court is the center of power of an independent but complex series of courts of various jurisdictions. There are four branches of the courts:

1. General Courts (including the Commercial Court)
2. Religious Courts
3. Military Courts
4. Administrative Courts.

These courts have been granted various degrees of special extended jurisdiction. The Children's Court, Human Rights Court, the new Industrial Relations Court and the Commercial Court falling under the jurisdiction of the General Courts and the recently created Tax Court falling under the jurisdiction of the Administrative Courts.

The newest specialized court is the Anticorruption Court, which was created in conjunction with the creation of the Commission to Eradicate Corruption (KPK). It began hearing cases in late 2004. The KPK has the authority to investigate and prosecute 30 types of corruption cases that meet specific criteria.

To date, only one Anticorruption Court exists as a special court under the Central District Court of Jakarta. Prior to the creation of the Anticorruption Court, all corruption cases were part of the General Courts' criminal caseload. Most corruption cases (those not prosecuted by the KPK) are still heard by the General Courts.

While the Anticorruption Court has received public support, there are serious constitutional challenges and obstacles to its operations, which limit its effectiveness and ability to deal efficiently with its current caseloads. As of this writing, the Anticorruption Court has processed approximately 40 cases. It is estimated that over 20,000 corruption complaints are pending investigation and delayed due to limited resources available to the court and the commission.

The main four branches of the courts stated above are courts of first instance as well as appellate courts. Historically, these courts have had their organizational, administrative, and financial affairs administered by the respective Ministers of the relevant Departments: the Minister of Justice and Human Rights for General Courts; the Minister of Religious Affairs for the Religious Courts; and the Minister for Security and Defense Affairs for Military Courts. The technical legal and judicial aspects of court administration were always the responsibility of the Supreme Court. However, recent reforms to the judiciary have put the organizational, administrative, and financial functions of these courts come under the auspices of the Supreme Court. This is commonly referred to as the "one roof" system.

The Commercial Court, established in 1998, is not a separate tribunal, but was organized through a differentiation of the Court of General Jurisdiction into distinct areas of expertise. The Law on Judicial Power (Article 10) and the Law on the Court of General Jurisdiction (Article 8) authorize this approach and provide for the establishment of areas of differentiation or specialization within the basic court systems.

The statutory basis for the Commercial Court is contained in Bankruptcy Law Articles 280 and 281. These articles make clear that the Commercial Court was originally designed not only for bankruptcy cases, but for other commercial matters as well. Currently, the Commercial Court has handled many but not all of the cases relating to IPRs (e.g., patent, trademark, copyright, industrial design, and integrated circuit design), except for cases regarding trade secrets.

In the first three months after its establishment in 1998, the Commercial Court handled 31 bankruptcy cases. The number of cases has declined ever since. Interviewees cite the dramatic decline in the use of the Commercial Court as a clear indication of litigants' disappointment in the court, especially with regard to the post-decision process.

Court administration in Indonesia is regulated in a very fragmented manner. One frustrated researcher of the court's history stated, "At present there is no court administration." Provisions are contained in various regulations, which can be categorized into two levels. The first level is the basic principles of court administration, which are usually specified in formal legislation. These types of regulation establish only the main principles of court administration and typically require further elaboration in order to be implemented. The second level constitutes the more detailed rules on court administration issued by the Supreme Court in the form of manuals.

The current trend in court administration is moving toward an even more fragmented regulatory model. Basic regulations on court administration are not only in procedural regulations such as the Procedural Code (only parts of which are still in force), but also in other legislation, such a the Basic Law on Judicial Power, the Law on the Supreme Court, and the law regarding the Court of General Jurisdiction. Further, court administration is significantly regulated by substantive laws (i.e., laws regulating specific matters such as competition). As a result of the fragmented character of the regulatory framework, different judicial procedures and therefore different court administration procedures are required for different laws.

In an effort to provide a coherent regulatory framework, the Supreme Court has published court administration manuals, which codify fragmented regulations in several books. The content of these manuals is taken from laws, Supreme Court regulations, and other procedures developed specifically for the manuals. These manuals do not have the force of law and therefore are not binding. They only serve as guidelines for court implementation.

The problem of fragmented regulation exists in the Commercial Court as well. As a court established by the Bankruptcy Law, the Commercial Court has a set of administrative principles that have their source in various laws and regulations. Additional procedures for the Commercial Courts come from the Bankruptcy Law and from the set of IPR laws, which establish the authority and jurisdiction of the Commercial Court.

This mix of regulations is exacerbated by the fact that the District Court and Commercial Court have overlapping jurisdiction. For example, an entire bankruptcy case can be manipulated out of the Commercial Court by filing a claims dispute in the District Court. The same court researcher quoted above, stated hyperbolically, “There really is no Commercial Court!”

Implementing Institutions

Judges. Judges in Indonesia are managed in a “closed career system,” except for the judges of the Supreme Court. Specifically, a judge is recruited from law school graduates soon after graduation. There is a maximum age of 25 to apply for becoming a judge.

In the Supreme Court, the model is not based on the traditional career system. Judges are politically appointed by the parliament, and the term of office lasts until judges retire when they reach 65 years of age. Supreme Court judges can be recruited not only from among career judges, but also from among other legal practitioners and legal scholars. Although it is not a career system, leadership positions within the Supreme Court are usually appointed among the most senior judges.

Judges are fairly well paid as compared with other civil servants with similar civil service rank and positions. However, , in general the compensation is considered insufficient for judges in view of their status as important officials in the administration of justice at the national level. Indonesian courts have poor operational and supporting facilities compared with other government working units in the same levels.

The opinion of the public and other state officials regarding judges is relatively low. The public assumes a certain level of corruption, collusion, and nepotism. In an effort to combat this, the Supreme Court has recently adopted a very strict Code of Conduct for Judges. It is so detailed and rigorous that it is difficult for a judge to receive small gifts or even to play golf with his or her lawyer friends. Another problem is the assignment of duty stations. In this system, transfers to a variety of courts is obligatory for a judge before he/she can be promoted to a better position or better court location. Transfers occur approximately every three or four years. Transfer decisions were made by the Ministry of Justice in consultation with the Supreme Court. Today some say the process has reversed.

Unfortunately, this system is not supported by sufficient infrastructure, such as a performance appraisal system, significant continuing legal education, or supervision. Also, there is no employee data management system, and almost all decisions to transfer judges in Indonesia are arbitrary. This system not only wastes money, but also nurtures corruption, collusion, and nepotism in the transfer and placement process. The only advantage to this process was noted by a few respondents who conceded that becoming comfortable with the idea of "strangers" from other provinces on the bench can serve to foster a sense of nationhood.

Court clerks. Court clerks in Indonesia have two functions. The first is to assist judges in the courtroom, even to the point of drafting opinions, and in case administration. The second function is the office management function, which includes finance, the procurement and maintenance of court equipment and office supplies, etc.

There are two types of court clerks in the Indonesian court system: the court clerk of the court of first instance and the court of appeal, and the court clerk in the Supreme Court. The Supreme Court clerks are recruited from active and senior judges, and most of them are selected directly by the Supreme Court justices to assist them. Court clerks in the Supreme Court receive the same salary as active judges and enjoy the privilege of career advancement to important and strategic positions. That is not the case for court clerks in lower courts.

In Indonesia, the position of court clerk is seen as an inferior position within the court system. Their authority is low, the remuneration is poor, and there is relatively little prospect for career development.

Many studies have examined the poor quality of judges in Indonesia, but the quality of court clerks is rated far lower than that of judges. One of the sources for recruitment of court clerks is from among candidate judges who failed to become permanent judges. Thus, policy makers, the bar, and the public see court clerks (and also court administration) as a relatively unimportant aspect of the judiciary. Very little effort has been directed toward improving the situation of court clerks.

Because of the tendency to regard court clerks as second-class staff, they have been left out of most of the reform process, with foreseeable results: there has been little progress in improving their performance.

There is widespread misunderstanding about the potential of court clerks to play a role in reform. Decision makers view the court clerk as simply an executor of court administration. This perspective is not entirely correct. The court clerks must also understand the substantive law to fully assist judges in deciding cases. If the legislature passes a proposed Freedom of Information Law, and if court records are to become truly public, it will be the court clerks who will implement this new openness. Because of the tendency to regard court clerks as second-class staff, they have been left out of most of the reform process, with foreseeable results: there has been little progress in improving their performance.

Finally, there is no clear career path for court clerks. Promotions and transfers are based on an unspecified performance appraisal process, which is known to be very subjective. Laws require that transfers and promotions of court clerks are to be directed by the Supreme Court.

The Supreme Court has insufficient staff to monitor the court clerks and no means with which to exercise disciplinary measures, influence promotion, and transfer decisions. Judges to whom clerks are assigned conduct daily supervision. If the judge is corrupt, the clerk merely serves as the gatekeeper for bribes.

The Commercial Court. The Bankruptcy Law established the Commercial Court as a special chamber under the Court of General Jurisdiction. The original jurisdiction of the court was limited to bankruptcy cases, with the provision that such jurisdiction was to be expanded to other commercial cases through government regulation. To date, the government has established Commercial Courts in five district courts in Indonesia. In the Commercial Court, the administrative functions (i.e., court clerk's function and secretarial function) are consolidated and supervised by one of the court clerks of ordinary civil cases. This has been a disadvantage for the Commercial Court, because they must rely on administrative units already known for poor performance rather than have the solid administrative underpinnings that were expected.

Court administration in the Commercial Court is similar to that in the ordinary courts. Most instruments are still paper-based. The use of advanced information technology is rare and not well organized. For example, computers are often used only as a replacement for typewriters. Cases are submitted to the court in paper form and are manually registered and numbered chronologically in the court register. Case assignments are based on the discretion of the Head of the Court. Timekeeping management is conducted loosely. However, there is some reporting on the case backlog in the Commercial Court. The case backlog in the Supreme Court has dropped from 12,000 to 9,000 in recent years.

Record management is conducted manually. After a case is concluded, the case materials are bundled in a folio-sized document holder and put on the archive room shelves. Because the courts still use manual filing systems and improper storage methods (no climate control, anti-dust measures, etc.), court archiving faces the serious problem of a limited space with continually increasing numbers of archives. There are also problems with the durability and security of the documents, especially in the provinces, with respect to theft, weather, and natural disasters. In addition, the archives are not designed for easy retrieval of case files. In fact, there are no transcripts to retrieve because there are no court reporters. The clerk keeps notes of the proceedings, but these have been known to be altered, sometimes as a result of bribes. What records there are often cannot be retrieved without written permission from an unspecified number of judges. This system of record keeping is public in name only.

In the enforcement of court administration, judges are considered very lax. For example, the Commercial Court is reluctant to use "injunctions" for IPR cases or seizure of assets in bankruptcy cases. In addition, many enforcement actions relating to these processes are not structurally supported by the implementing agencies (e.g., police and auction authorities). For example, the attachment of assets generates frequent complaints from practitioners that the entire asset is seized or attached, even though this bears no relation to the amount of the claim being enforced.

Interviewees also cite major problems with corrupt practices in enforcement and a general lack of competence and capacity among court clerks and bailiffs. Indonesia theoretically recognizes the enforcement of foreign judgments on the basis of reciprocity; however, to date Indonesia has few reciprocal agreements in place. Foreign judgments cannot be enforced with any certainty.

Another important aspect of court administration is the unbalanced court clerk workloads and the lack of discipline in the court administration process. Commercial Court clerks are clerks of the ordinary civil court with the additional assignment of handling commercial cases. The result of this is not only an unbalanced workload, but also a split of focus for the court clerks working on the commercial cases. Lack of discipline is regarded as a critical problem in the Commercial Court. Formal procedures are relatively useless, since there will likely be an officer who will offer to neglect the procedures.

Indonesian courts do not receive sufficient funds to fully and fairly operate. The court has two sources of income: the state budget and the case-handling fee. One potential source of income is case-handling fees, but the state budget system does not allow the court to directly use the case-handling fee paid by parties to cover the court's routine expenses. Financial accountability and auditing are only required for funds received from the state budget. Courts often refuse to be audited on the use of case-handling fees. The argument is that case-handling fees belong to the third party, thus, neither the state nor any private auditors have the authority to audit them. In fact, this is not true for the Commercial Court, where the case-handling fee is paid in advance, determined as a fixed amount, and is not intended to be returned to the litigants if there are any outstanding balances. In reality, requests for a receipt for any case-handling fee are ignored.

Supporting Institutions

Non-Governmental Organizations (NGOs). There are many NGOs that focus on legal development, including those that monitor the court. Several NGOs have some experience on the Commercial Court, including the Center for Indonesian Law and Policy Studies (PSHK),Pusat Pengkajian Hukum or Center for Legal Research (PPH), and the Centre for Information and Law-Economic Studies(CINLES). Another prominent NGO that focuses on the Commercial Court is the Indonesian Anticorruption and Commerce Court Enhancement (In-ACCE) Project. It assists both the Anticorruption and Commercial Courts in achieving the objectives of the Supreme Court's reform strategy outlined in the blueprints for reform adopted in 2004.

All of the NGOs assist the Steering Committee of the Commercial Court in developing systems and the human resources of the Commercial Court by conducting studies, writing annotations to court decisions and, in particular reference to court administration, developing of manuals for Bankruptcy.

Lawyers and bar associations. Lawyers are regarded as important players in court administration. However, they are viewed as the party primarily responsible for the collusion and corruption within the court administration. It is true that the court clerks are the gatekeepers of corruption, but many lawyers do not take the trouble to pursue the established administration process. They pay one or two court clerks to fix the process on their behalf with additional unofficial payments ("speed money"). Further, some lawyers argue that it is ethical to bribe court officials to work efficiently in order not to overcharge their clients.

Bar associations do not play a significant role in court administration. Law school graduates can immediately practice as legal consultants without any certification requirement, though they need certification to appear in court. To appear in court, legal consultants are required to obtain certification from the state. The bar association federation is now conducting bar exams on an open, honest basis, preventing students from buying their way into the practice.

There are two levels of lawyer certification in Indonesia. The first level is as a *pengacara* (lawyer). After obtaining the license, lawyers can practice only within the province in which they obtained the license. After handling a certain number of civil, criminal, and religious cases, depending on the province, a lawyer can submit an application to the Supreme Court to become an *advokat* (advocate). Advocates are allowed to handle cases anywhere in Indonesia. Until very recently, bribes were used to avoid the above certification procedures. The Law on Advocates Profession (Law No. 18 of 2003) may gradually improve this situation by providing a political instrument that facilitates the reform of the bar associations.

Bar associations do not consistently discipline their members. Bribery and collusion are tacitly accepted as common practices.

Bar associations are beginning to provide continuing legal education for their members. Some associations organize training on bankruptcy law on an ad hoc basis, but the main subject of such training is the substance of bankruptcy law, instead of the court administration itself. It is taken for granted that court administration is a matter that all lawyers can easily understand and exercise.

The Association of Indonesian Judges (Ikatan Hakim Indonesia [IKAHI]). Some consider IKAHI successful in its role as a judge association. It is a forum where judges of all levels and regions communicate their professional concerns. While the Supreme Court organizes judges' substantive training, IKAHI organizes their social activities and professional communication forums.

The Supreme Court is making a new push to be attentive to the need of court administration. As the highest authority in the administration of justice, the Supreme Court has a paramount role in matters of court administration. All matters of court administration are now under the supervision of the Secretary General of the Supreme Court. The Center for Research and Development in the Supreme Court is a division within the Supreme Court that facilitates and implements programs designed for court officials and funded by foreign donor agencies.

Agency for National Development Planning (Badan Perencanaan Pembangunan Nasional [BAPPENAS]). BAPPENAS is an agency that implements the authority of the Ministry of National Development Planning. Its main function is to facilitate coordination among government agencies that conduct national development. It provides a master plan for national development, including law making and judicial reform. Also, it acts as an entry point for bilateral and multilateral funding. In this sense, BAPPENAS plays a strategic role in judicial reform, including the development of court administration. Its role as a development coordinating agency is highly regarded. BAPPENAS is also an important supporting institution in court administration because it is able to facilitate the creation of new ideas. However, there is

some question over whether BAPPENAS will continue to receive its earlier level of funding. This may become an issue in the coming elections.

The Steering Committee of the Commercial Court and the Working Group of the Commercial Court. Following the establishment of the Commercial Court, the government and the Supreme Court took the initiative to set up new institutions to deal with the improvement of the Commercial Court. The intention from the outset was that the Commercial Court should be a model professional court with a high degree of integrity. International financial institutions (IMF and the World Bank) and foreign donor agencies funding judicial reform efforts in Indonesia strongly supported this plan.

The Steering Committee is considered to be very supportive of the development of the Commercial Court, including its court administration. It consists of judges, high officials from the Ministry of Justice and BAPPENAS, and prominent legal scholars in business law. Under the coordination of BAPPENAS, its roles include giving direction for the development of the Commercial Court and providing solutions for the problems encountered by the Commercial Court. Since its establishment in 1999, it has effectively provided new concepts and services to improve quality of Commercial Court judges. The overall performance of the court, has been mixed and its future as a preeminent venue for commercial disputes remains in doubt.

Donors. The donor community endeavors to support the area of commercial dispute resolution in Indonesia. USAID has been particularly active in the area of court reform. The Indonesia Anti-Corruption and Commercial Court Enhancement Project seeks to improve the administrative practices of the commercial courts so that they will be a model for efficiency and honesty throughout the country, thereby contributing to increased public confidence generally.

Social Dynamics

Traditionally court administration has not been viewed as an important aspect of the legal system in Indonesia. Compared with other aspects of law reform, such a substantive law, the judges, and the bar association, only a relatively small group of stakeholders has focused on court administration. There is no codified legal framework for court administration in the Commercial Court, and it is difficult to identify a clear court administration procedure. The legal framework for court administration is defined by many laws, regulations, and manuals issued by the Supreme Court. There is a tendency to regulate court administration procedures on an ad hoc basis each time a new special court is introduced.

Also, the Steering Committee of the Commercial Court and BAPPENAS lack the same enthusiasm (or budgets) for court administration projects that they did in 2004. The intense focus on the Anti-Corruption Court and other specialized courts has made court administration less of a priority than it already was.

Also, there is no effort on the part of the implementing agencies to utilize advanced information processing technology, which could make the system more efficient. Further, both the implementing agencies and the lawyers, who are the direct users of the court administration system, are infected by the corruption that is deeply rooted in Indonesia. Bribery and collusion are commonplace.

Despite these conditions, there are plans and for improving the situation. There remain significant supporting institutions in the Steering Committee of the Commercial Court, in cooperation with BAPPENAS, which have a specific interest in Commercial Court administration. Under the supervision of the Steering Committee, the Manual on Commercial Court Administration (MOCCA) for Bankruptcy has been published in a prominent legal website in Indonesia (www.hukumonline.com).

International and domestic business communities are strong advocates for reform, while the government wants to see better court administration as part of an improvement in the business environment. The international and domestic business communities are backing the government as it strives for reform by working with organizations such as the Steering Committee and supporting the continuing influx of foreign funds. On the other side, resistance from certain implementing institutions can be overcome with strong political action of the Chief Justice and important Supreme Court justices. With these systems in place, there is optimism that reform will take place.

Reform of the court system may entail reform of law, institutions, or the people who run the system. Regarding court administration in Indonesia, much needs to be done on all three fronts.

Recommendations

There are some relatively inexpensive changes that could aid reform.

- Develop and integrate the practice of court reporting by maintaining transcripts from court proceedings. Court reporting represents a first step toward transparency. The Attorney General and the Corruption Eradication Commission (KPK) could videotape all court proceedings in the Anticorruption Court and make copies available to all parties and the court itself. It is the beginning of true transparency.
- Publish judicial opinions on court and/or private websites.
- Use the newly revived judicial commission to select and train judges to improve competence on the bench.
- Make a series of small, low-cost efforts to diminish petty corruption. For example, post signs in the clerk’s office that say that failure to give a receipt for any court fee is a criminal offense and should be immediately reported to the police.

FOREIGN DIRECT INVESTMENT

Introduction

Foreign direct investment in Indonesia has begun to rebound following the Asian financial crisis, due largely to the resumption of growth in the region and to some reforms to the laws and regulations facing foreign and domestic investors. In the process, the origin of foreign investment has significantly changed, with more investment now coming from Japan, China, Singapore, and other Asian countries and less from Europe and North America. Some of that investment is quasi-foreign in that it represents Indonesian businesses repatriating domestic capital that was moved offshore following the financial crisis of 1997-98.

Foreign investors and those who provide support services to them cite the following impediments to Indonesia attracting the levels of FDI that could drive growth and employment to target levels.

Comparing Indonesia to the world:

Ease of doing business
World Bank *Doing Business in 2006*
135 out of 175

Economic Freedom
Heritage Foundation
Index of Economic Freedom 2007
110 out of 157

Corruption
Transparency International
Corruption Perceptions Index (2006)
130 out of 163

GDP per capita (purchasing parity) $3900
CIA World Factbook (2007)
176 out of 232

Unstable policy/regulatory environment. Some investors are unnerved by increased uncertainty of the investment climate. However, most are hopeful that the enabling environment is generally improving and acknowledge that unpredictability is a necessary byproduct of democracy.

Modest commitment to an open economy. Although Indonesia does have some passionate advocates of openness and competitiveness, and the government does have stated goals of increased international trade and direct foreign investment, this agenda is not as high a priority as it has been for some the Asian "tigers," who have aggressively promoted export-oriented growth as their engines of modernization. The difference may lay in Indonesia's huge domestic market and in its recent tradition of oligopolies and state-owned enterprises. As a result, progress in reforming the investment climate is slow.

Corruption. Although corruption has long been endemic in Indonesia, investors find it more unpredictable now than it was during the Suharto years. A single bribe to a senior official might or might not suffice. Other demands can surface at any time. Such uncertainty is a business risk and makes Indonesia a costlier place to do business than several of its regional competitors. A number of respondents felt that Indonesia will solve its corruption problem only with comprehensive civil service reform.

Civil service reform. Indonesia's civil service impedes business efficiency as often as it facilitates it. With poor pay and automatic promotions based on academic qualification, most officials show little initiative. And with the press increasingly covering corruption-related issues, risk-averse bureaucrats often avoid decisions, most commonly by pushing them up to the highest

possible levels of the government, where they compete for the Minister's attention with scores of other routine decisions. While reducing the role of government in business operations (for example, by eliminating some approvals and license requirements) will help, even the most basic, legitimate functions of government will not operate efficiently until salaries, incentives, business processes, and organizational structures are comprehensively reformed. This is not likely to happen before the 2009 elections, if at all.

Commercial dispute resolution. The court system is corrupt and unpredictable, so investors do not count on justice or even timely resolution of commercial disputes. As part of the IMF reform package following the financial crisis, Indonesia established a Commercial Court with regional branches, and extensive donor assistance has been provided for judicial training and staffing. Courts issue written opinions, which NGOs that focus on law reform monitor and publicize. It will likely be years before this problem disappears from the list of investment disincentives.

Tax administration. Investors find the administration of the tax system more of a disincentive than the tax rates themselves. Assessments appear arbitrary and subject to extortion, and a business can only pursue a refund or a protest by first posting the full amount of the assessment and then pursuing it doggedly through the courts.

Decentralization. Because it is still new, the administrative decentralization based on Law No. 32 of 2004 still causes misinterpretation of law and regulation. The business community alleges that there are 2,000 discrepancies between national laws and regulations and those promulgated by the local districts and municipalities, and that there are differences in law and regulation from region to region. However, most investors are optimistic that these inconveniences will be reduced and that they will learn to do business around the country.

Corporate governance. Development of a culture of corporate governance that protects the rights of minority investors is still in its infancy in Indonesia. Some businesses cite weaknesses in this area as an impediment to rapid growth in FDI.

Labor laws. Labor Law reform began in 1998 with technical assistance provided by the International Labor Organization (ILO) and the United States through an ILO/USA Declaration Project. This resulted in three Labor Laws, including Law No. 21 of 2000 regarding Labor Unions, Law No. 1 of 2003 regarding Manpower, and Law No. 2 of 2004 regarding Industrial Relations Dispute Settlement. In January 2006, the Industrial Relations Court was officially established as part of the implementation of Law No. 2 of 2004. The current labor law – in particular Indonesia's excessive requirement for severance pay– increases the cost of business and discourages investment.

Infrastructure. Indonesia has made almost no investment in additional power generation, roads, or port capacity since the financial crisis of the late 1990s. Thus inadequate capacities continue to constrain operating efficiencies and discourage investors. Realizing the importance of this problem, Indonesia is planning its first substantial increase in public spending on physical infrastructure for 2008 and plans to encourage public-private partnerships in some of the resulting investments.

Legal Framework

Indonesia's new law on capital investment, Law No. 25 of 2007 regarding Capital Investment passed by the Parliament March 29, 2007, is a modest step forward in promoting the country's competitiveness in attracting foreign investors. It:

- Provides for equal treatment of all investors, foreign and domestic
- Precludes nationalization of private investments except where prescribed by law, in which case compensation must be based on market value with disputes settled by arbitration
- Allows free international transfer of assets and repatriation of profits
- Provides improved guarantees of land tenure, including the right to build for 80 years, the right to use for 70 years, and the right to exploit for 95 years
- Provides additional clarity on visa and residence requirements for foreign investors and their foreign employees
- Allows for the development of special economic zones to promote exports and employment.

The new law also mandates a one-door integrated service for all investor licensing and approvals and provides for investment incentives, although the specifics are left to subsequent implementing legislation. Somewhat vaguely, the law obliges investors to implement principles of good corporate governance and to create a healthy business competition climate.

The prescribed form of foreign capital investment under the new law is the Limited Liability Company (PT), except where otherwise permitted by law. In contrast to the old law (Law No. 1 of 1967) which prescribed a limited time frame of up to 30 years for foreign capital investment, the new law prescribes no time limit for foreign capital investment in Indonesia. There are three ways of undertaking foreign investment in the form of a Limited Liability Company: by taking shares at the time of establishment of the Limited Liability Company; by purchasing shares from an existing Limited Liability Company; or other mechanisms in accordance with existing regulations.

There are incentives for investors who expand an existing investment or who make a new investment. These incentives can be in the form of a reduction of net income; a release from or reduction of import duty for importing capital materials, machines, or other equipment needed for production which cannot be produced domestically; a release from or reduction of import duty for importing raw material or support for production; facilitation of permit and immigration matters; or a release from or postponement of value added tax for imported capital materials or machines or equipment needed for production. There are also incentives in relation to land tenure, immigration, and permits.

Article 12, paragraph 3, Law No. 25 of 2007 states that the government, through Presidential Regulation, prescribes a negative list both for domestic capital investment and foreign capital investment based on: health, morals, culture, environment, defense and national security, and other national interests.

On the negative side, the new investment law:

- Requires that investors give priority to Indonesian labor
- Reserves for the government investments in non-renewable natural resources with high risk of environmental destruction; integration and communications functions across provinces, and national defense and security
- Provides that certain business sectors may be legislated as off-limits to foreign investors (including the handcrafts made by and traditional technologies employed by small and medium-size businesses
- Reserves the right of the government to mandate local equity participation in certain industries (notably infrastructure, transportation services, and extractive industries) to protect the environment or other national interests.

The Capital Investment Coordination Board (BKPM) developed and presidential decree implemented the government's "negative list," which spells out the specific restrictions on investors by industry.. As of July 2007, BKPM had developed an updated negative list and sent it to the Coordinating Ministry for Economic Affairs for inter-ministerial review, to subsequently be passed on to the President for approval. BKPM's stated intention is to make the new negative list clearer and more detailed than earlier versions in order to enhance the transparency and predictability of the investment-approval process and reduce opportunities for arbitrary decisions on approvals.

One weakness of the Capital Investment Law is that it does not specify how BKPM should coordinate its foreign investment activities with the local governments. The law also conflicts with a regulation on one-stop service for business licensing that provides that the local government has the authority to issue business licensing and approvals in its district. There is now an effort to correct this discrepancy by putting the one-stop service under the local BKPM.

To date the President has issued two Presidential Regulations in order to implement Law No. 25 of 2007. Presidential Regulation No. 76 regards Criteria and Requirements to determine Business Sectors that are closed and Business Sectors that are open with regard to Capital Investment. Article 5 of this regulation stipulates criteria including: simplicity, commitment to international transparency, legal certainty, and the unity of Indonesian territory as a single market. Based on the simplicity principle, business sectors are to be declared open nationally and closed to a limited degree in cases that relate to national interest. In principle the regulation contemplates that only a small portion of all economic activity and a small proportion of economic sectors will be closed to capital investment, whether foreign or domestic. The other regulation, Presidential Regulation No. 77, regards the list of business sectors that are closed and those that are open with regard to Capital Investment. It states that 25 business activities are closed to capital investment both domestic and foreign, including : gambling/casinos, museums, *adat* (customary law) environments, monuments, natural reefs, catching fish listed in Appendix I , bus and ship terminals, cultivating cannabis, and alcoholic drinks. The maximum share that may be acquired by a foreign investor for other categories of capital investments that are open vary based on the business activities. Shares of foreign capital investment may range from a maximum of 49 percent in sectors such as education and internet shops, to up to 95 percent in sectors such as mining and energy and certain communication and agricultural sectors.

Indonesia's Labor Law No. 1 of 2003, enacted during the Megawati administration, constitutes a major impediment to investment and is in need of an overhaul. The labor law is punitive to investors through its requirement for burdensome severance payments to terminated workers – by far the largest severance requirements in the ASEAN region. This requirement increases the overall cost of labor, discouraging some investors from investing and reducing the international competitiveness of labor-intensive businesses. Many managers evade this requirement by hiring labor on contracts of less than two years, but such a situation does not encourage investment in worker productivity or loyalty to employers.

Although it is unlikely that the labor law will be reformed before the 2009 elections, a consensus, which includes major labor unions, is evolving that the current labor law needs to be revised. To make a change politically feasible, a moderate payroll tax that could fund unemployment insurance and/or a retirement benefit may need to replace the high severance pay requirements. To promote political dialogue on such a change, it would be useful to fund an economic model of the employment effects of reduced severance requirements. Revision of the labor law is on the priority agenda of the National Law Commission.

Implementing Institutions

Significant elements of Indonesia's political leadership have a reform agenda that, if implemented, would encourage foreign direct investment. The ministers of finance and trade are committed reformers, and the coordinating minister of economy is intent on accelerating privatization of state-owned enterprises. However, their challenge is to implement reforms through an entrenched civil service, set in its ways and often perceiving itself as benefiting from the status quo.

The key implementing institution is the **Capital Investment Coordination Board** (BKPM), responsible for approving investor applications, for administering the negative list, for recommending investment incentives, for implementing the government's new "one door integrated services" policy, and for promoting investment opportunities to potential investors. Under the newly enacted investment law, the BKPM's chairman reports directly to the President, a move meant to signal increased importance of facilitating new investments. To implement the one-stop shop, BKPM is constructing, adjacent to its headquarters, a new office building to house representatives of 18 Indonesian ministries charged with approvals or continuing services to investors.

BKPM is also responsible for administering a system of investment incentives, known locally as "facilities," to encourage investments in 15 priority sectors or to induce investors to remote areas where jobs are scarce. The most common of such incentives are tax holidays and reduced rates of taxation. The ministry of finance must approve all changes in tax incentives.

BKPM senior staff report that the chairman has set a goal of reducing investment approvals to a maximum of 10 days, and that he would like to dispense with investment approvals altogether, since businesses will still be obliged to obtain the relevant permits and licenses to operate. To deal with the complexities of the recent decentralization, the chairman would like to spread norms and standards across all provinces and eventually to the districts and municipalities, but specific plans and authorities for doing that have not yet been developed.

BKPM is taking steps to improve its accessibility and its outreach to investors. Its website offers more complete information and includes basic interactive features for investor inquiries. The agency now produces for the public a series of printed booklets explaining investment regulations and procedures. And the government's planned budget for 2008 will include, for the first time, funding for Indonesian commercial officers to be posted overseas to promote the country to foreign investors.

Supporting Institutions

Indonesia's **court system** is corrupt and unpredictable, so investors do not count on just verdicts or even timely resolution of commercial disputes. As part of the IMF reform package following the financial crisis, Indonesia established a Commercial Court with regional branches, and extensive donor assistance has been provided for judicial training and staffing. Courts issue written opinions, which NGOs that focus on law reform monitor and publicize. It will likely be some years before this problem disappears from the list of investment disincentives, and as a result, many large businesses prefer to use offshore international arbitration, typically in Singapore, to solve commercial conflicts.

The **Coordinating Ministry of Economic Affairs** prepared a 2006 investment climate package of legal and regulatory reforms and is working on a 2007 package.

The **international community** of donors and lenders is involved in improving the business-enabling environment and has a donor group that meets irregularly on the subject. The World Bank, the International Finance Corporation (IFC), and the Asian Development Bank are active among the multilateral institutions. USAID has projects addressing the commercial courts, and both USAID and the Millennium Challenge Corporation (MCC) are assisting the Indonesian government in combating financial crimes and corruption.

The **business community** interacts with the Indonesian government on a range of investor concerns. The major actors are the Indonesian-American Chamber of Commerce (Amcham) and the Indonesian chamber of commerce, KADIN. Foreign investors judge both to be engaged and relatively effective in representing business concerns to government.

Social Dynamics

Key individuals in government and the business community drive reform of Indonesia's investment climate more than public opinion. While Indonesia is slowly overcoming the legacies of over-regulation and state ownership, change is incremental, and vested interests are reluctant to relinquish long-standing roles and influence. Furthermore, democracy is a slow and messy process. While Vietnam was able to decree rapid changes in its investment climate through executive decree and quick parliamentary approval, development of a political consensus among Indonesia's many independent stakeholders is a much more uncertain prospect, especially given the short timeframe within which democratic institutions such as the Parliament have been operating.

While the legacies of over-regulation and state ownership are being slowly overcome, change is incremental, and vested interests are reluctant to let go of long-standing roles and influence.

There is not much public debate about the benefits of increasing FDI. While Indonesian newspapers sometimes cover the complaints of foreign investors, media coverage of economic and investment issues are neither comprehensive nor sophisticated. Informed media coverage of both sides of the issue on severance pay requirements, for example, could lay the groundwork for productive public debate and possibly reform.

NGOs are generally not influential in advocating for or against FDI. Exceptions include KADIN, with whom the parliament regularly consults on draft legislation, and the labor unions, which are generally protective of jobs in state-owned enterprises. However, the non-government sector has been vocal on the issue of privatization. Some of the earliest cases between 2003 and 2007 heard by the newly-established Constitutional Court concerned privatization in the electricity and natural resources sectors; the Court gave NGO groups an opportunity to argue against privatization. Although the labor unions pushed hard for Indonesia's current high levels of required severance pay, some high-level labor officials privately concede that such payments discourage new employment, and that alternative worker safety-net measures should be explored.

Recommendations

- Commercial court judges should have to publish their decisions on the Internet within three days of the completion of a case.
- The court should follow the lead of the newly-established Anti-Corruption Court by assigning ad hoc judges from among academics and other civil society actors who have good character, integrity, and expertise.
- Print and broadcast journalists should be trained in coverage of economic and business issues. Exchange programs with western journalists should supplement this training.
- Best practices in licensing and permitting should be disseminated to the provinces, districts, and municipalities so that these recently decentralized functions can be made less unpredictable throughout the country.
- Bureaucracy must be reformed. It is urgent to apply good governance principles and change the culture of government officers from officials holding power to civil servants providing services.
- The endeavors to eradicate corruption must be continued. This effort is very important to reduce the high cost of investment.
- The labor law should be revised to reduce required severance pay to levels consistent with the rest of the ASEAN region. To secure cooperation in this reform of organized labor, a modest but predictable payroll tax could be instituted to fund unemployment insurance and pensions.
- Indonesia should reinvigorate its program to privatize state-owned enterprises, many of which serve as sources of funding for political campaigns and costly drains on public finance, and most of which crowd out more competitive private investments.
- BKPM should further reduce the scope of the negative list, which prohibits private investment in certain sectors and restricts foreign participation in others. The consumers of all goods and services would benefit from increased competition.

INTERNATIONAL TRADE LAW AND POLICY

Introduction

Growth in Indonesia's trade has been relatively stagnant in the years since the Asian recovery, and the value of exports and imports has roughly kept pace with prices. Even the 33 percent nominal growth from 2004 to 2005 was due more to price increases in primary commodities than to growth in volume, indicating no real improvement in the competitiveness of Indonesian exports.

Merchandise Trade in $ millions[73]					
	2001	2002	2003	2004	2005
Exports	56,317	57,159	61,058	64,484	85,660
Imports	30,962	31,289	32,551	42,948	57,701
Surplus	25,355	25,870	28,507	21,536	27,959

While the composition of exports has shifted only marginally in recent years, the most significant change has been a reduction in manufactured goods from 54.1 percent of exports in 2002 to 46.9 percent in 2005, as Indonesia has faced increasing competition in labor-intensive industries, such as textiles, clothing, and footwear, from China and Vietnam.

Over the same period, Asia's share of Indonesia's imports and exports has grown (to 67 percent and 68.3 percent, respectively) as the share of Europe and the United States has fallen. Japan remains Indonesia's largest export market, at over 21 percent of merchandise exports, while Singapore has surpassed Japan as the largest source of Indonesia's imports (16.4 percent). Trade is not growing among ASEAN countries, although there is significant potential for such growth if ASEAN countries take measures to harmonize policies and procedures in the region.

Legal Framework

Indonesia has no trade framework law. Today's trade laws are based on the Dutch civil and commercial codes, and until 20 years ago the university law school used those Dutch texts. When the law volumes were translated into Bahasa Indonesian, they were abridged, so today's legal texts do not contain all the details, including case examples that elucidate the intent of the law upon which today's trade disputes are based, of the Dutch codes. With its thousands of islands and huge domestic market, domestic trade is a very important driver of Indonesia's economy, and the country needs a trade framework law that covers both domestic and international law.

Indonesian scholars and policy makers are aware of the need for a framework trade law. The Faculty of Law at the University of Indonesia, for example, cooperated with the Department of Industry and Trade in preparing an academic draft of a codified Trade Law in 2003, but to date it has not become law.

[73] UNSD, Comtrade database

The need for a framework trade law is obvious when considering the number of Indonesian laws and regulations in the trade area. Key regulations related to international trade include Law No. 10 of 1995 regarding Customs as amended by Law No. 17 of 2006 and Law No. 20 of 1997 regarding non-tariff state revenue. Tariff or non-tariff revenues are determined by taking into account the impact on community and business activities, government revenues generated by non-tariff state revenue activities, and justice aspects for the community or people (article 3 Law No. 20 of 1997).

There are many other regulations governing implementation, such as the Government Regulation No. 46 of 2003 regarding imported and/or certain strategic goods that are exempted from value-added tax. This regulation includes the import of certain goods, such as capital goods that are needed for production, livestock food, poultry and fish, and seeds for agriculture, plantation, and forestry. Other regulations, including Government Regulation No. 146 of 2000, as amended by the Government Regulation No. 38 of 2003 regarding imported and/or certain strategic goods that are exempted from value-added tax, such as guns, ammunition, tanks, patrol vehicles, polio vaccines, general books, holy books and religion books, ships, planes, trains, and supporting equipment for ships, planes, and trains.

Not surprisingly, the Ministry of International Trade has also issued numerous decisions and regulations, such as the Ministry of Trade Regulation No. 31 of 2007 regarding Importer Recognition Numbers. Based on this regulation, generally only trade companies, industrial companies, contractors or capital investments which already have a recognition number (API) can import goods. Another important regulation is the Ministry of Trade Regulation No. 32 of 2007 regarding the Decision on Export Price Stake for Certain Export Goods. Export price stake is decided based on average international price and or average FOB price at some port in Indonesia. This price is decided every month and forms the basis for determining export tariffs.

A WTO member, Indonesia ratified the Agreement Establishing the WTO on November 2, 1994, by Law No. 7 of 1997. International trade rules are based mostly on international conventions. However, Indonesia has not enacted all the legislation and regulations it committed to under the Uruguay Round. The Ministry of Law and Human Rights has drafted a law on e-commerce, which will soon be subjected to public review in the parliament. Indonesia provides at least most favored nation treatment to all WTO members.

Until recently, Indonesia has relied more on the multilateral trade provisions of the WTO and ASEAN than on developing a network of bilateral investment treaties. Indonesia has participated in negotiations of ASEAN regional trade agreements with Japan, China, and South Korea. ASEAN and Australia have concluded a trade and investment framework agreement (TIFA) and are now working on a free trade agreement. Indonesia has signed a trade agreement with the D8 Islamic countries and is negotiating an economic cooperation agreement with Japan (its largest trading partner) and trade agreements with South Africa, EFTA (Europe), India, and Pakistan.

Since 2001 Indonesia and the United States have been engaged in developing a TIFA, which will lay the groundwork for a subsequent bilateral free trade agreement. The two countries recently signed a textile memorandum of understanding (MOU), which addresses, among other things, the re-labeling of Chinese textiles as Indonesian. Indonesia is studying the potential

benefits and costs of free trade agreements with Pakistan and India. It has executed bilateral agreements in 2007 with Bosnia and Herzegovina and Qatar.

Pursuant to the terms of its WTO membership, Indonesia has substantially removed barriers to international trade. To date no import tariffs have exceeded the Indonesian undertaking on rates, as stated in the Indonesia Schedule of Commitment under WTO Agreement.[74] There remain a few quotas on imports and exports, however, particularly on agricultural items. Although in general Indonesia has not freely allowed rice imports, it recently began importing rice from Vietnam. The Halal requirement is a non-tariff barrier. The domestic trade network, on the other hand, is far more rigid. Trading licenses, for example, often come with strings attached, like a requirement to trade to a remote island.

The tariff is Indonesia's main trade policy instrument, although it only accounts for about four percent of tax revenues. The average applied MFN tariff is 9.5 percent (2006), and 95 percent of tariffs are 10 percent or less. Over 99 percent of applied tariff rates are *ad valorem*, which promotes transparency, although with 16 different *ad valorem* rates the system could be simplified.

Implementing Institutions

Indonesia's current **Minister of Trade** is a reformer, committed to opening her country to the benefits of global competition. The Ministry's strategic vision is "to realize the trade sector as a main driver for increasing national competitiveness and the welfare of the Indonesian people."

The Ministry is responsible for international trade, domestic trade, and supervising the commodity futures markets. Of the Ministry's 2,918 staff, 1,248 work on international trade in the Division of Foreign Trade, the Division of Trade Cooperation, the Agency for Export Development, or the Trade Research and Development Agency.

However, the overall effectiveness of the Ministry and of the various trade-related implementing agencies is poor. The Ministry staff, like the entire civil service, is generally underqualified, underpaid, and poorly motivated, and has an operating budget inadequate to carry out its functions effectively. The anti-dumping unit in the International Trade Cooperation Division, for example, does not fully monitor, investigate, and bring cases across the spectrum of its imports. However, it has been active in initiating anti-dumping investigations regarding base metals and chemicals from the region, however. The majority of the Ministry's staff is between the ages of 46 and 55 and lacks a university degree.

While comprehensive civil service reform is the long-term answer, the Ministry, with assistance from AusAID, has developed a training needs assessment, which identifies the following priority areas for the development of technical skills:[75]

- Formulating and implementing domestic trade policy
- Formulating and implementing international trade policy

[74] WTO Trade Policy Review of Indonesia: replies to Questions Raised by Argentina, June 27 and 30, 2003.
[75] Ministry of Trade Training Needs Assessment (draft report), Derry Habir and Greg McGuire, February, 2007

- Formulating and implementing export promotion policy
- Human resources management.

The generic skills most in need of enhancement are strategic planning, management, legal analysis, databases and statistics, computer use, and English proficiency.

Within the Division of Trade Cooperation, the government has established a National Trade Negotiating Team, responsible for trade strategy and the coordination of negotiations. Although several bilateral trade agreements are under consideration, the philosophy of this unit is that, in the long term, the multilateral trading system is the best option for Indonesia.

Supporting Institutions

Other government agencies central to international trade suffer from the same inadequacies of budget and staff quality. For example, the staff of the **Business Competition Supervising Commission** receives significant donor-financed training but has yet to bring to prosecutors many cases for non-competitive behavior.

Although having a reputation for being incorruptible, the Director of **Customs** has not yet been able to significantly reduce the bribery endemic to Customs assessments and port clearances. While such bribes are generally within acceptable limits and are normally charged on an *ad valorem* basis, they still distort the benefits of international trade as much as higher tariffs would. Recent innovations like pre-shipment certification, which makes Customs evaluations less arbitrary, may help to stem this tide, as should the comprehensive use of e-commerce tools.

Trade finance became harder to secure after the Asian financial collapse of 1997. **Local banks** have become more conservative and risk-averse, focusing mainly on their larger, more established customers and leaving most of the new trade finance business to foreign banks in Indonesia and banks operating abroad. Similarly, most exporters use foreign insurance companies or local companies in partnership with the large international insurers.

Special economic zones (referred to as export processing zones or free trade areas) have been tried several times in Indonesia, usually to promote employment through labor-intensive exports. Most have failed due to insufficient infrastructure and investment and corruption. The one exception is the **Batam special economic zone**, which benefits from its proximity to Singapore, from where much of the investment comes, and the success of the zone's director in attracting significant government investment. Batam is designated as a special economic zone based on Law No. 36 of 2000 as amended by the Government Regulation Substitution Law (Perpu or Emergency Law) No. 1 of 2007. Law No. 36 of 2000 stated that Free Trade Zone shall be established by Law. The Emergency Law No. 1 of 2007 stated that the Free Trade Zone is established by government regulation. There are some implementing regulations such as Government Regulation No. 63 of 2003 regarding Implementation of Value Added Tax and Tax on Luxury things in Bonded Zone Batam Island, amended by Government Regulation No. 35 of 2005 regarding Export Tariff for Certain Export Things. There are four types of products not included in the tax exemption: electronic products, automotive products, alcohol, and tobacco.

The Indonesian **shipping industry** is not a factor in international trade. Several lines were badly managed and went bankrupt. However, Indonesian shipping still plays an important role in domestic shipping due to government requirements that domestic trade be conducted largely by domestic carriers.

Social Dynamics

While the Minister of Trade and the Ministry's secretary general are both internationally respected free traders, they have found it difficult to implement free trade principles. In addition, public demand for trade liberalization has not been strong. Press coverage is less prominent on trade issues than it is on investment issues, and media advocacy for reform is weak, with the exception of agitating for Customs reform. The low profile of international trade issues in Indonesia than in other ASEAN countries may be because of Indonesia's huge domestic market. The imperative to drive growth through exports is not as strong in Indonesia. In fact, Indonesia leads the G-33, a retro-protectionist group, which Malaysia and Thailand have refused to join.

KADIN, the Indonesian chamber of commerce, has some analytical capability and considerable political influence, and is the most effective of the professional groups advocating for trade liberalization. But, with the exception of the textile, steel, and wheat associations, most industry lobbying groups are weak.

Recommendations

- The development and effective execution of trade policy and the effective facilitation of trade transactions depend on comprehensive civil service reform. With donor assistance, civil service reform could be developed prior to the 2008 elections and implemented soon thereafter.
- Just and timely settlement of commercial disputes requires the continued development of independent commercial courts.
- Graft and inefficiency in the Customs department substantially increase the costs of imports. The increased use of e-commerce will make Customs transactions faster and more transparent and decrease the face-to-face contact that provides opportunities for corruption.
- Increasing popular support for trade liberalization would help enable reform. Donors could support training for Indonesian journalists in coverage of economic issues and establish exchanges with foreign economic reporters.

FLOW OF GOODS AND SERVICES

Introduction

The cost of moving goods across international borders is now as important as tariffs in determining the cost of landed goods. The ability of countries to allow delivery of goods and services quickly and at a low cost is a key determinant of their participation in the global economy. Easier movement of goods and services clearly drives export competitiveness and foreign direct investment. Delays in border formalities can raise the cost of goods and hurt a country's competitiveness with its trading rivals. Also, a reputation for inefficient and ineffective Customs and international logistical regimes will discourage international companies from doing business in a country.

Indonesia's government is mindful of the importance of effective trade facilitation, exhibiting a refreshed commitment through the development of a new Customs law and through a very effective new leader in the Customs department. But whether a new Customs law will be properly implemented remains to be seen, and corruption at the border continues to undermine Customs reform. A wide variety of challenges face importers and exporters, transporters, brokers, and other members of Indonesia's trade community.

Legal Framework

A modern Customs service has to strive for transparency, predictability, and fairness in its dealings with the international trade community. For a truly facilitative environment, it is critical that the laws and regulations governing the import and export of materials and goods provide:

- An adequate and coherent authority structure for the essential trade-related institutions
- Clearly stated regulations and procedures that form a basis for an adequate balance between facilitation and necessary controls essential for public health and welfare
- The means to legally employ modern risk management techniques utilizing selective inspections and post-release audits to accomplish their respective goals
- A productive environment of cooperation and procedural coherence with the other government agencies that have border control responsibilities
- A cooperative and consultative atmosphere of dialogue between government agencies, the international trade community, and the national legislature in order to accomplish goals and eliminate roadblocks.

Indonesia is implementing a new Customs law that will assist the country in taking steps to achieve these objectives.

Indonesia's new Customs law. In 2006, Indonesia amended its Customs law with the assistance of major donors, reform-minded legislators, and Indonesia's executive authorities. The new law, "Draft Law on Amendment to Law Number 10 Year 1995 on Customs," has not yet been published in an official English version and was not available for review, although Draft translations were available. However, important implementing regulations are still being drafted and are not publicly available.

The new law is intended to address many of the issues that the international trade community, donors, and this report identify. The law has been drafted with the main objectives of improving predictability and legal certainty for traders, carriers, and intermediaries; preventing and deterring Customs fraud; increasing supervision of critical items, especially for terrorist and illegal related items; improving the Customs business process to better serve the compliant trade community by simplification and automation; and achieving greater consistency with WTO standards and agreements.[76]

With over 40 regulations or ministerial stipulations needed to fully implement the new law, it remains to be seen what kind of effect the Law will have. Nonetheless, certain observations can be made at this time.

Many of the changes are aimed at punishing and imposing fines on violators of Customs laws. The goal of enforcement actions is to encourage importers to comply with Indonesia's Customs law and regulations. If Customs can identify compliant companies and remove most border controls for those companies, it can direct resources to working with companies with low or unknown compliance levels.

Unfortunately, the fines and penalties have been increased to draconian levels. Also, the fines are confusingly stratified and should be simplified. Mitigation and appeal processes should be outlined in the implementing regulations to eliminate Customs' discretionary authority as much as possible while making the resulting decisions transparent to oversight bodies. The expansion of discretionary authority could increase corruption and integrity violations.

New provisions provide Customs with domestic authority over "certain goods" such as drug-making paraphernalia and goods associated and terrorism. This provision does not conform to other Customs agency practices, will overlap with other Indonesian law enforcement bodies, and will provide previously unavailable opportunity for corruption.

A code of ethics for Customs employees is provided, as are sanctions for its violation.

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[76] "The recovery and expansion of international trade in recent years has intensified the public demand for greater legal certainty and more efficient government services that impinge on trade costs and competitiveness. The most recent World Bank review of the ease of doing business (Doing business in 2006: Creating Jobs) ranks Indonesia 115th out of 155 countries. It took, on average, 30 days to import and 25 days to export in Indonesia compared with 13 days to import and 8 days to export in New Zealand. Part of the reason for Indonesia's lagging performance according to the McKinsey Global Institute is "inefficient Customs and port services" with the time to clear Customs averaging 5.8 days compared with just 3.6 days in Malaysia and 2.8 days in the Philippines. Informal payments at Customs were reported by 82 percent of respondents to a survey conducted by LPEM-World Bank, including 43 percent who responded that they made such informal payments "frequently". These informal payments added 2.3 percent to the cost of imports on average. The increasing competition for investment and markets in the region and globally dictate that a country's Customs services, as a key component of the logistics chain, be efficient and clean. This is vital in Indonesia towards improving private sector compliance with laws and regulations and with avoidance of smuggling and Customs fraud, which deprive the government of revenue and create chaotic business conditions". Excerpt from unpublished "Review of Draft Law on Amendment to Law Number 10 Year 1995 on Customs", Draft report prepared by William E. James, Nathan Associates, Inc. on behalf of the World Bank.

The revised law, provides for dispute procedures with Customs. Adjudication procedures and appeal processes are not delineated.

Customs value laws are now consistent with WTO value provisions and rules of origin. However, they are not referenced to the ASEAN rules of origin, which may cause confusion for traders within ASEAN.

Procedures for Voluntary Disclosures are provided for the first time. A Voluntary Disclosure is for individuals or companies who voluntarily come forward in good faith to disclose errors and omissions in exchange for reduced or no penalty.

Implementing Institutions

The **Directorate General of Customs and Excise (DGCE)** is the principal government agency for border control that provides the traditional responsibilities of the lead border agency. The major functions of DGCE are:

- Determining the value of goods and collecting the related Customs revenue
- Supervising, detecting, reporting, and preventing smuggling
- Detecting and evaluating violations of Customs law
- Participating in preparing and signing international agreements and conventions in Customs matters, in accordance with Customs legislation
- Assisting other federal border agencies with quarantine, health, and safety responsibilities in the fulfillment of their missions
- Carrying out all other activities such as export reporting and enforcing export controls, as determined by Customs legislation
- Preparing, collecting, and distributing foreign trade statistical data to the National Statistics Office and other public institutions
- Supervising Customs goods throughout the entire Customs territory of Indonesia by regulating international carriers, importers, exporters, and intermediaries
- Exercising Customs control over Customs areas
- Maintaining Customs records.

To perform these duties, DGCE has a complement of approximately 11,000-12,000 civilian Customs officers and support personnel responsible for policy, executive management, enforcement of Customs laws, and revenue collection.

The DGCE's reputation has improved over the last several years. Interviewees respondent cited DGCE's improved responsiveness, although they also cited remaining challenges such as inefficiency and widespread corruption. The Minister of Finance is reportedly concentrating her efforts on reforming the **Directorate General for Tax (DGT),** including a complete reorganization of the Tax Department. This is a prudent for the Minister because Customs duties represented only 3.0 percent of national revenues in 2006 and are estimated to drop to 2.6

Benefits of APC status include:

- Lower examination rates (1 percent)
- Much lower bribes
- Release time in minutes
- Greatly reduced logistical costs

percent in 2008 as further duty reductions and trade agreements take effect. [77] Despite issues it needs to address, DGCE is recognized for progress in several areas.

"Gold Card" or "Priority Lane". The DGCE has established a special program for 94 compliant large importers (approximately 60 percent of the total import value of a wide range of goods to Indonesia, not including agricultural products) to speed their goods through Customs formalities. The DGCE implemented this reform in 2003 under IMF guidance. Numerous countries have adopted this "Gold Card" approach to allow their limited resources to focus on high-risk shipments while providing tangible benefits to legitimate businesses; Indonesia is the first country in the region to adopt such a program. The next logical step for the program is to treat these companies as accounts, appointing Customs-employed account managers and instituting a special set of compliance, risk criteria, and post-release audit for select companies. This would offer those companies "Priority Lane/green line[78]" or expedited service and separate their shipments from the flow of riskier imports. Similar programs in Jordan, Egypt, the United States, and Canada has provided a high level of trade facilitation while assuring that the companies admitted to this program remain compliant and therefore remain low-risk.

In response to the DGCE effort, the trade community has established an Association of Priority Clients (APC), which meets regularly among with DGCE. Although they complain that the application process and program functions are confusing and opaque, the association members expressed great satisfaction that the DGCE has begun to establish a relationship with them.

The APC reports that enhancements to the program are planned during 2007 with the establishment of a special Customs office for priority client coordination. Seventeen Client Coordinators will direct the program and act as the principal interface with priority lane coordinators.

The **Minister of Finance** and the **Director General** are driving reform in the DGCE. However, many respondents felt that only the top echelon has the vision and fortitude to support real reform and that middle-level managers and officers are wedded to the status quo. The Director General has an internal reform program that was not made available for this assessment.

[77] Please note that Customs also collects VAT, Income and Excise taxes and is a significant contributor overall secondary to DGT.

[78] The DGCE uses unique definitions for inspection lane treatment: Internationally, RED means full document review and physical inspection, YELLOW means document review only and GREEN means neither document review nor physical inspection occurs. In Indonesia, RED means full document review and physical inspection, the same as other Customs services. PRIORITY LINE, however, is the equivalent of the international GREEN with no document or physical inspection. Indonesia's GREEN requires a full document review; accordingly, it is the equivalent of the international YELLOW.

The DGCE has undertaken dramatic gestures to indicate the willingness to reform and that it is not afraid to make changes . For example, at Jakarta International Soekarno-Hatta Airport over 2,000 Customs officers will be rotated and replaced with newly trained officers.

Anti-corruption efforts are bearing fruit. Although still a major problem of staggering proportions, one respondent reports that, "[There] isn't one person in Customs that doesn't know someone from Customs that is in jail or currently under trial." The Indonesian Corruption Commission (Komisi Pemberantasan Korupsi (KPK)), the Minister of Finance, and the DGCE's internal resources are given much of the credit.

Indonesia is now readying a test of its **National Single Window** for late 2007 in Batam. This action will precede a proposed ASEAN Single Window that is slated for implementation in 2012. The test will include the use of a Single Administrative Document (SAD) for all the major federal agencies at the border, as well as an electronic data exchange of import/export documentation between the ASEAN countries. Although delayed, the future innovations and improvements that are possible with the test could have major implications for the Indonesian trade community. However, major hurdles such as the lack of automation and history of poor coordination between Indonesia's various border agencies must be overcome for benefits to be applied nationally.

Automation. The DGCE has an automated system that is not up to the level of other Customs systems for import or export transactions. Respondents indicate that the system does not provide benefit to them or facilitate foreign trade. The DGCE has asked that various donors fund ASYCUDA World, a more comprehensive and efficient automated Customs system, but the requests have not been successful. The current system is fragmented and lacks the basic functionality of an effective platform and the basis to conduct efficient and effective business processes. In order for automation to be successful, business processes must also be changed to reach the full potential of the system.

The **carrier manifest process** needs to be fully automated, with the resulting data being used for targeting or selectivity. Failure to activate and implement the manifest function means that import entries and export declarations cannot be reconciled automatically with the carrier's reports (bills of lading/airway bills) of manifested goods. In addition to improving the accuracy of matching, un-released shipments can be readily identified, which is more efficient than the current manual processing. The source carrier data can also be used for targeting and selectivity. Most importantly, analysis of the combined data set of entry and manifest can reveal potential integrity violations. For example, one officer who releases multiple shipments for a single shipper would not be a normal occurrence; usually, one officer would service numerous importers and therefore the possibility for collusion would be high. Additionally, the shipments may contain incorrectly declared merchandise for resale and even contraband. Automated manifest processing is the norm for most of the world's other Customs administrations and carriers are ready to provide it in Indonesia as well.

A data warehouse is an excellent source of data for monitoring and evaluating the performance of the port personnel: For example, the number of declarations that are designated RED/YELLOW/GREEN and in the case of Indonesia PRIORITY LINE, can be monitored and if the results/findings of the declarations are recorded, the efficacy of the physical examinations

can be monitored. The data can also be used for a variety of purposes such as targeting companies for post-release audit, analyzing trends, and measuring release times.

Additionally, an automated system can provide the foundation for the proposed Single Window concept in which all the federal agencies with data needs are served or the system is used to perform required selectivity functions. The system can also be used to receive electronic licenses, permits or certificates eliminating paper filings for the other control authorities. This will simplify import transactions and reduce costs for the trade.

Improvements to **collections** can also be made using automation especially for the larger and more frequent payers. Accumulating payments for multiple entries into lump sums on daily or weekly basis instead collecting of individual checks or payments per each declaration can ease the burden on the private sector, Customs' cashiers and cooperating banks when combined with an ACH payment feature. Additionally, a more sophisticated automated collections process could be used to ferret out bogus surety bonds and guarantees presented by unscrupulous traders.

Lastly, respondents did not express confidence in the accuracy of Indonesia's **trade statistics**. The inadequacy of the current Customs automated system is at the heart of this problem. Edits and complete matching between carrier and importer/exporter data are essential for a reliable and timely trade statistics.

Risk Management. Risk Management is a systematic approach to making decisions under uncertain conditions by identifying, assessing, understanding, planning for, and communicating risk issues. It forms the basis for selectivity and is the single most important facilitative measure that a Customs administration can take. For Customs and border agencies, it is means to move from an attempt to achieve total control of documents and goods for *every* shipment as it arrives in the country to a rational, data driven process to select only high-risk cargo for document review or intensive physical examination. Most countries have adopted the risk management approach to facilitate the international movement of goods from compliant importers while devoting their Customs and other control agency resources to goods that have the highest potential negative impact on revenue, the economy and especially the health and welfare of its citizens. Risk management deployment simply means that a large proportion of international shipments can cross the border quickly with no inspection and minimal formal requirements. As a result, opportunity for bribe solicitation and payment is reduced because of increased transparency and the removal of Customs officer's opportunity to hold cargo for bribe solicitation.

The ability to capture transaction data in a modern automated system such as ASYCUDA World provides the essentials for a risk management regime to a Customs administration. It also accesses the power of the internet for the collection of data and communication between Customs, the other border agencies and various members of international trade community.

Modern Customs Risk management principles are not followed in Indonesia, with the exception of DGCE's **Priority Line program.** Examination rates are high and document review rates are 100 percent. Face-to-face encounters with DGCE are inevitable and bribery opportunity and collusion abounds. In the absence of a modern automated system, Indonesia is unable to achieve the benefits of risk management.

Post-Release Audit. Post-Release Audit is an excellent means to verify compliance and refine risk management techniques. A Customs Post-Release Audit is not viewed as a financial audit – rather, it serves to determine the level of compliance with all Customs laws and regulations applicable to importers and is an evaluation of company practices and records. It assists in judging the integrity of information supplied in the Customs declaration and the importer's level of compliance with Customs legislative requirements. Customs' overall aim should be to achieve private sector compliance on a company-by company basis while being assured that the company's import department is knowledgeable of Customs' laws and regulations. True compliance exists when systems and/or departments at importing companies are aware of and take steps to comply with Customs laws and decrees. This includes internal company audits and self-assessments.

In Indonesia, post-release audits are used for the Priority Line members as well as other importers. Contrary to international practice, audits are unannounced. Trade representatives stated that audits appeared to be random and not data driven.

Corruption. Indonesia's corruption is among the worst in the region. Despite improvements, virtually every knowledgeable person interviewed for this assessment acknowledged that persistent, widespread, and deeply rooted corruption was an inherent part of doing business in Indonesia. A recent American Chamber of Commerce survey of Southeast Asia reported: "In Indonesia, 86 percent of AmCham members polled felt corruption was a significant factor, in Malaysia the figure was 51 percent, in the Philippines 72 percent, Thailand 63 percent and in Vietnam 67 percent."[79] Consistently, DGCE and the DGT are mentioned as the most corrupt agencies.

Customs administrations face three main areas of corruption:

- Facilitating payments: importers (or the Customs broker or a representative) pay bribes to obtain a normal or trouble free release.
- Customs complicit fraud: importers try to pay a lower amount of duty, taxes, and fees than competitors that are following the law, by circumventing procedures. This can involve other control agency jurisdictions such as food purity and plant/animal quarantine strictures. Customs officers either ignore or are actively involved in the fraud. Free riders then are able to sell goods in the marketplace at a greater profit than their law-abiding competitors.
- Criminal corruption: operators pay bribes to permit an illegal, lucrative operation from drugs and other contraband to arms and munitions).

Interviewees reported that all three types of corruption exist in Indonesia. Most face-to-face meetings during a Customs transaction involve a facilitating payment. Most troubling to the trade community is the practice of Customs-complicit fraud, since it gives advantages to the free riders while placing law-abiding businesses at a competitive disadvantage. Other border agencies

[79] "Corruption a major concern for US firms in SE Asia: Survey, 08 June 2007 2004 hrs (SST), URL: http://www.channelnewsasia.com/stories/afp_world_business/view/281054/1/.html

complain of the third type of corruption, where adulterated foodstuffs, counterfeit prescription drugs and goods subject to plant/quarantine restrictions are released without scrutiny.

Supporting Institutions

Supporting institutions include:

- Public institutions (other border agencies)
- Importers and exporters
- Transporters – road, rail, and marine
- Customs brokers and freight forwarders
- Bonded warehouses
- Special economic zones
- Trade associations and public-private partnerships

Although the DGCE is the main implementing institution for the movement of goods, an efficient trading system relies upon an interdependent process that includes other trade-related public sector institutions, trade service providers *and* the traders themselves—importers and exporters. Clearly optimized trade facilitation depends on the supporting institutions' active involvement. A Customs administration that is not supported by a compliant, automated, and sophisticated private sector will not achieve a high degree of facilitation. Additionally, like the DGCE, the trade-related public agencies also need sound management, well-trained staff, modern equipment, modern facilitative procedures, and active dialogue with the trade community to respond timely and predictably to issues while guarding the public safety and security of the country. The private sector trade community also adds their expertise and familiarity with expert legal and logistical knowledge to the import/export process, and is crucial to the efficiency and overall compliance of international trade movements.

Likewise, the other agencies with responsibility for the health and safety of the people of the Indonesia and other duties such as trade statistics, environment, and endangered species must be receptive to and able to use Customs' sophisticated automated platform.

Public institutions. The traditional border agencies, including those examining the health and safety of imports, are present in Indonesia. Most approvals are based upon pre-filing and pre-approval for goods falling under their jurisdiction. Interviewees did not report any significant delays or burdens with either clearances by Agriculture agencies or the National Agency of Drug and Food Control (BPOM).

The traditional private sector institutions that support international trade include importers and exporters; customs brokers and freight forwarders; sea and road transporters; port authorities; economic zone operations and trade associations.

Currently, there is limited coordination between DGCE and the other control authorities—each trader or Customs clearance agency must arrange its individual clearance and forms containing duplicative information on the same shipments. Additionally, if physical inspections are required by any agency, then separate inspections are conducted. Thus two examinations take place on many shipments. Also, each agency places its own "holds" on shipments, causing control difficulties. Each agency reported that many shipments are released erroneously because of port confusion or because of corruption. In addition, no training in the other control authority responsibilities and enforcement threats are given to Customs officers in the field or at the DGCE training center.

Traders reported that the full spectrum of business processing for imports and exports at the ports "are a mess". One respondent stated that up to 29 stops were required for shipments, that there is no "single window" for federal agency processing, and that local government and other legal entities can and do arbitrarily place checkpoint and control points for traders to negotiate.

Private Institutions. The efficiency of the private supporting institutions directly involved in the logistical supply chain, from manufacturing source to the importer/exporter, is critical in keeping transaction costs low and increasing the competitiveness of the international trader.

Who seeks and receives "informal fees?"

- The police along the highway
- The gate attendant at the port
- Port personnel responsible for loading and unloading the cargo
- The Customs officer who moves the paperwork through the process

Importers and exporters encounter significant problems in trying to move their goods in and out of the country. Although they note limited improvements in streamlining the process, reducing corruption, and improving logistical services, the pace of progress remains slow. The regulatory environment for the international trader continues to be onerous as the Indonesian government tries to control the domestic consumer market. Infrastructure issues continue to be unresolved. These issues are even more important in Indonesia, where the trade community must keep controllable costs low to offset higher labor costs and lower productivity standards than many of its neighbors.[80]

Regulatory requirements in Indonesia are high, with approximately 20 percent of imports and exports needing **licenses and permits from multiple public agencies** that do not coordinate or cooperate to simplify the process. These products include furniture, coffee, food, and timber. For example, if a company secures a license to import, that permit might set limits to the parties to whom the importer can sell. Since 1995, all exporters must have an executed memorandum of understanding (MOU) with Customs certifying that they are legitimate enterprises, a practice unique to Indonesia within ASEAN. The Department of Agriculture examines and quarantines all imported cotton, which is mainly from the United States, for five to 10 days, even though the United States government certifies the product to be free of pests and of good quality. Many countries accept such certification as a matter of routine.

Although there are major international entities in Indonesia that both import and export, the vast majority of importers and exporters are small and medium-size firms. A major factor contributing to the cost of importing and exporting for these firms is the small volume of goods shipped. In fact, 75 –to-80 percent of the cargo through the major port of Tanjung Priok, excluding the multinational firms, is "less than container load" (LCL).[81] Such shipments incur

[80] According to figures from the Ministry of Labor, labor costs in 2007 in Indonesia average $0.76/hr. while China pays $0.55 and Vietnam $0.35. Of even more significance, in trying to compete with neighboring countries for investment, Indonesia also ranks significantly behind countries like Thailand, Malaysia, China and the Philippines in productivity.

[81] LCL A general reference for identifying cargo in any quantity intended for carriage in a container, where the Carrier is responsible for packing and/or unpacking the container. For operational purposes a LCL (less than

additional transport and handling charges for stuffing and unloading services at departure and arrival ports.

The trade community reports that **informal payments** are a major impediment to trade facilitation and a significant cost factor. At each human intervention in the process of clearance, companies pay small facilitating payments[82]. Estimates are that such informal fees constitute up to 35 percent of the total inland costs, which, depending on location, range from $200 to $500 per container, or about 10.8 percent of annual production costs. Percentage of payments for smaller firms is generally higher than those for larger, more influential firms.

Informal fees are reported to have increased in recent years as the result of decentralization. They vary by region, with Jakarta being the most expensive. Informal fees are both expected and anticipated by authorities and reportedly may figure into the rationale for lower official compensation for public officials. An excessively rigorous regulatory environment is often used to generate these indirect payments as the system user tries to ease the burden and shorten the import/export process. The government has taken steps to eliminate regional and local authority in some areas where these practices are most detrimental to business.

The **industrial sector** accounts for about 65 percent of all non-oil exports, with the largest segment represented by textile producers. Statistics from the Central Board of Trade indicate that textile exports, including garments and fabric, increased from $6.88 billion in 2002 to $9.47 billion in 2006 and are the largest export sector outside of non-petroleum and natural gas products with 13 percent market share. International market share during this same period decreased from three percent to two percent.

The **garment industry**, the largest textile trade component, is composed of about 2600 manufacturers, 70 percent of which are domestically owned. Most produce the final garment starting from the fiber and are located (85 percent) in Java. Smaller producers are in Bali, Sumatra and other regions. Seventy-four percent of production is exported, principally to the US (41 percent) followed by the EU (19 percent) and Japan (five percent). Unfortunately, the domestic market is no longer viable due to the high penetration of smuggled goods.

Although garment firms import raw materials, principally cotton from the United States, few operate within special economic zones that would expedite both their import and export process and reduce their duty liability. The principle reason they do this is the lack of predictability and clarity of the rules pertaining to these facilities. Imported inputs are less than 10 percent of production costs, which contrasts sharply with a country like Vietnam, where 70 percent of inputs are foreign-sourced. The DGCE in the zones themselves report problems with export certification from the DGCE port personnel.

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full container load) container is considered a container in which multiple consignees. Freight costs are higher per weight because of extra documentation and handling costs.

[82] A facilitating payment is a payment for "routine governmental action," such as obtaining permits, processing papers, providing normal government services, etc. It is, in fact, a bribe, but usually a small one that does not induce any smuggling or exceptional behavior.

One of the major issues confronting the industry (and one which could jeopardize market access to the US) involves the illegal transshipment of textiles to the US through Indonesia. The decentralization of the issuance of Certificates of Origin has generally reduced the quality and reliability of the certificates and expanded the opportunity for corrupt behavior. The government is cooperating with the US in investigating suspected companies.

Other issues confronting the garment sector in particular but international traders in general include the following:

- Insufficient access to credit (lending institutions consider the textile trade to be particularly volatile) and interest rates among the highest in the region when available. More than 90 percent of the spinning and weaving machinery is over 10 years old with the majority over 20. The results of the government plan to allocate up to $10.4B in 2007 for textile machinery restructuring are unknown to stakeholders.
- An inefficient import and export process including lack of coordination between government agencies.
- Inadequate infrastructure.

Of serious concern to both importers and exporters who would also like to sell their products on the domestic market is the widespread illegal domestic black market trade in Indonesia (estimated to have reached about $2.5 billion in 2006). This mostly involves consumer goods such as textiles, shoes, and electronics. In a 2006 survey, the textile industry found that roughly 50 percent of garments on the domestic market were entered illegally. They arrived at this conclusion by comparing domestic consumption with the combined quantity of both imported goods and local production. The severity of this problem hinders investment, denies the government legitimate revenue, and places the honest trader in an uncompetitive position.

A significant group of importers, some of them major players in Indonesia's economy, have organized networks to conduct this illegal trade and distribute the goods. Such actions are fairly common, conducted with the full complicity of Customs, port, and police officials and have become an acknowledged method of expeditious import clearance provided that all parties deem the payment sufficient. Although historically this activity occurred at the smaller ports and generally involved such goods as second hand clothing, the scope of the current problem now indicates that smuggled goods are now moving through major ports such as Tanjung Priok and Tanjung Perak, the two largest port facilities in the country, both of which are located on Java. The government's efforts to address this issue have been ineffective to date.

It is cheaper to import citrus fruit from China into Sumatra than to transport the domestic product from Java to Sumatra.

Transport sector. Of critical importance to Indonesia, which relies on sea transport, is port efficiency. Trade volumes depend on port efficiency, and poor port performance limits trade growth. A November 2006 study for the U.S. Army Corps of Engineers indicated that a 10 percent increase in port efficiency leads to a minimum 3.2 percent increase in trade, while another study in 2000 showed that an increase in port productivity from a 25 percent to 75 percent level would result in a 25 percent increase in trade. Many factors contribute to

determining that level of efficiency, including facilities, connections to rail and trucking lines, harbor characteristics, Customs clearance times, and labor relations.

Port operations and road transport are inefficient in Indonesia, resulting in high logistical costs that absorb about 14 percent of an export's final price. Although such costs are generally in line with other ASEAN countries, the cost in Japan averages only 4.88 percent. Each 10 percent rise in transport costs can reduce trade volume by 20 percent. Such distortions create scenarios in which, for instance, it is cheaper to import citrus fruit from China into Sumatra than to transport the domestic product from Java to Sumatra.

The principal reasons for these inefficiencies are lack of adequate infrastructure, particularly poor road conditions; inefficiency and lax management of the ports; and payment of unofficial fees. There have been no major infrastructure improvements during the 10 years since the Asian economic crisis. Because of the direct relationship between poor roads and ports with the high cost of doing business in the country, Indonesia has made infrastructure improvements one of its top four priorities for 2008. Recognizing that the government will only be able to directly fund about 17 percent of the projected $150 billion needed for infrastructure development until 2010, it is opening some of the priority projects to private investors.

Rail. Rail transport can often move goods in and out of ports at a lower cost and faster than overland. Plans for revitalization of the rail links to the major ports of Tanjung Priok and the Port of Bojonegara, a regency in East Java, are under discussion and involve some consideration of privatization. Such links could serve the textile export industry located in and around Badung. However, there is doubt as to whether these projects will be realized. State operator PT Kereta Api Indonesia has a current monopoly on all rail transport, which is used almost exclusively by state-owned enterprises to transport bulk commodities such as oil and cement. Air transport is not a significant factor in international trade, carrying only five percent of the total volume.

Road. Three hundred trucking companies, with a total fleet of 6,000 vehicles, operate in the Jakarta region. A few major firms with fleets of 200 or more vehicles dominate this field; the average company has about five trucks. Hauls are usually within a 200-km range around Jakarta and end or begin at Tanjung Priok, the major international gateway in Indonesia. Eighty percent of the fleet is in good condition, although composed of mainly imported used vehicles. However, seemingly simple matters such as the lack of wheel flaps on some trucks causes containers to become so dirty that the added cost of fumigation at the destination port is required.

National trucking associations, which all companies must join, are organized by region. Each publishes standard rates for hauling all types of cargo. Rates for the Jakarta area are established by distance to and from Tanjung Priok. The highest published standardized rates are $300 for a 20-foot container and $375 for a 40-foot container that is about 200 km from the port. Pick up and deliveries closest to the port are $90 to $120. However, since about 2000, due to an oversupply of fleet, rate reductions of about 20 to 30 percent are normal. With profit margins low, many of the smaller companies are being pushed out of the market.

The trade community rates the trucking industry as rendering only fair service, based on its costs, punctuality, and damage/loss records. Although trucking costs are generally in line with and in some cases lower than some of Indonesia's ASEAN neighbors, these fees could reportedly be

lowered by 20 percent with improved infrastructure and reduced informal payments. Estimates are that excessive fuel and maintenance costs due to poor infrastructure and gate delays add 10 percent, while informal payments add another 10 percent.

Most truckers complete only one haul per day, while the best practice within the ASEAN is three. Delays occur due to traffic congestion in and around the port and the poor condition of the roads in general. It is not unusual to wait two to four hours to enter the port, with further delays dropping off the load within the port limits. Although the distance between Tanjung Priok and the major industrial zone clusters is only about 60 km, trucks make a maximum of two round trips per day on the route. Decentralization, under which provincial offices received more authority for maintenance of roads and assessment of transport fees, has not led to improved conditions.

Deterioration of road conditions on the main transit routes to the ports is being accelerated by the current weight limits standards for trucks. Although the Public Works Ministry indicates that current road infrastructure can tolerate only a 25 percent overload capacity, trucks are currently allowed to travel 90 percent over capacity. Therefore, a truck with a one-ton capacity carries up to 1.9 tons, a measure allowed and tolerated because of the limited number of trips per day. Efforts are underway to reduce the overloads to 60 percent.

Generally, the shipper provides security personnel for the transit of export shipments because of the high theft and pilferage rates even while the cargo is within the port limits. Some exporters have cited this as one of the items that drives up export costs, which makes doing business in Indonesia more expense than in other ASEAN countries.

Marine. As the world's largest archipelago state, Indonesia relies on sea transportation to move its goods both domestically and internationally. As such, modern, efficient ports are required to keep time and costs at a minimum. Conditions within Indonesian ports are considered poor when compared with most ASEAN countries. Inadequate docking facilities and the poor condition and insufficient quantity of loading and unloading equipment are major drawbacks to efficient operations. In particular, Tanjung Priok is at capacity and can no longer support the demands placed on it.

The Director General of Sea Transport within the Ministry of Transport develops policy and oversees the ports, including regulating port fees. Four state-owned companies, Pelindo I to IV, whose jurisdiction is divided geographically, serve as operators of all the public port terminals with two major exceptions, the Jakarta International Container Terminal (JICT) at Tanjung Priok and the terminal operated by P & O Australia at Tanjung Perak. Although some divisions of Pelindo are attempting to address problems with the ports, including lack of human capacity, progress is slow and capital investment to make significant upgrade to port service is lacking.

Six million Twenty-Foot Equivalent Units (TEUs), intermodal shipping containers, were shipped in and out of the country in 2006. Of the 50 viable international ports of the 140 designated ports in Indonesia, Tanjung Priok handles about half of the total volume (2.7 million) and more than 50 percent of the value of exports and imports. In 2006, 5,351 foreign flag vessels, carrying a total of 59 million tons of cargo, called at the port. Other major ports include Tanjung Perak in Surabaya on Java, Belawan on Sumatra, and Makassar on Sulawezi**.**

Port fees are established through consultation and agreement among the trade associations that perform services at the port. The Ministry of Transport issues these fees, which vary from port to port. The Director General of Sea Transport under the Ministry of Transport makes a concerted effort to make fees competitive within the region. A recent new fee structure for warehouse and consolidation services performed within the port lowered existing rates.

Approximately 75 percent of all international cargo is carried on feeder vessels that carry between 300 and 600 TEUs per ship and travel between Jakarta and Singapore or Malaysia, where most goods are reloaded for final destination. There is a sufficient supply of vessels calling on the principal routes; international shipping rates on this route average $150 for a 20-foot container and $280 for a 40-foot container. However, the double handling of containers this stopover system creates adds a minimum of $300 per container to the cost of the international shipment. International shipping costs of a container sent directly from Jakarta to the EU is about $1,000, while the cost of that same container via Singapore or Malaysia is $1,315. Efforts to add direct service to Europe, Africa, and Australia have had limited success, and cargo on such routes often has to wait three to five days in port before loading, thereby incurring warehouse charges.

Berths to accommodate larger vessels are insufficient. Only four ports have the 12-meter depth at the berths to handle direct liner vessels. Available berths for incoming feeder vessels are also insufficient at Tanjunk Priok, causing loading and unloading delays of up to 12 hours. Major liner services can receive preferential treatment, due either to volume, a record of long service to the port, or informal payments. This situation causes unpredictability for the shipping lines that must meet published service schedules for the ports they service.

No modern information technology and communication infrastructure that would streamline and standardize procedures is in place at the ports, although such a program is standard at any modern port facility. These management systems incorporate and coordinate IT functions by the various government agencies, including Customs and the other border agencies, and integrate all terminal operations into one system to expedite arrivals and unloading. Although in 2003 the US Trade and Development Authority awarded a $555,000 grant to assist in the development of such a system at Tanjung Priok, there are no tangible results to date.

Movements within the port are slow due both to general congestion and burdensome procedures. A truck entering the port must make multiple stops and complete redundant paperwork before proceeding to pick up or delivery points. Implementation of a one-stop service within the ports would significantly increase efficiency.

Informal payments accompany every step in the process. Port personnel generally lack a service mentality and often have to be located and then encouraged, through the tip system, to begin the offloading process. Examples of informal fees cited include $20 for crane operators for a 40-foot container and $45 for port labor to stuff and unload a container at Tanjung Priok.

Terminal handing charges for containerized cargo are generally higher than most of the other ASEAN countries, due principally to lower productivity rates and lower cargo volumes. These are fees the foreign carrier assesses for the loading services paid to the port. Indonesian rates are $90 for a 20-foot container, compared to the Philippines at $78, Thailand at $40, and Malaysia at

$76 for the same service. Charges for handling bulk cargo average about $1.20 per ton and are among the lowest in ASEAN.

JICT is the largest container terminal in Indonesia and one of the three terminal sites located within the port of Tanjung Priok. Hutchinson Port Holdings (HPH) of Hong Kong, the world's largest independent container port operator, runs the terminal, owning a 51 percent share of the business. Privatization of JICT occurred in l99. At the end of HPH's 20-year lease, the operation will revert to Pelindo.

Although service at this terminal improved with privatization, there has not been the anticipated elevation of service to global standards. A recognized efficiency standard for port terminals is the number of container moves per hour, which measures the speed of loading and unloading. At JICT, the rate of 28 moves per hour (the highest in the country) is significantly below the accepted standard of 35 to 40 moves per hour. Inadequate and unreliable cranes coupled with the lack of a motivated labor force are contributing factors. However, the operator did install an automated container tracking system that allows the user to check the status of goods, an addition users welcomed.

Inadequate security is a serious problem at Tanjung Priok, although it has been certified as meeting the International Maritime Organization's (IMO) International Shipping and Port Facility Code requirements. Few of the 141 international ports in Indonesia have received this certification and a report is now pending to determine the status of many of the other ports. Port access is not well controlled; members of the surrounding community gaining easy entrance. This failure is primarily due to lack of cooperation and coordination among the multiple agencies assigned port security responsibilities, and that no clear policy indicates who the lead agency is.

One critical infrastructure project is the construction of a new international port to relieve congestion at Tanjung Priok, which and has little maneuverability to expand to meet current and future demand. There are plans to develop a new facility at Bojonegara, about 400 km from Jakarta, through private investment. The project is estimated to cost $722 million, will have a container handling capacity of 2.7 million TEUs, and is slated to be operational by 2010. The Ministry of Transport has put the first phase of the project on hold, however, reportedly because potential private investors wanted a guarantee that no similar port projects would be undertaken in the vicinity, except in the case of insufficient port capacity in the future. Those expressing interest represented many of the major international port operators, whose expertise could result in the construction of a world-class port facility for Indonesia. Another plan being considered is an expansion of Tanjung Priok through land reclamation.

Customs brokers/freight forwarders. Customs brokers or Customs clearance agents perform an important function by providing importers and exporters with expertise in Customs matters, preparing and submitting the formal declarations required for clearance, and acting as the client's representative before the border government agencies. When they are professional, knowledgeable, and have quality IT systems to manage the process, they can expedite clearance and lower transaction costs.

In Indonesia a Customs broker must prepare all import and export transactions. The DGCE trains, licenses, and regulates Customs brokers. Companies performing Customs clearance must

employ one person who has been certified by Customs, indicating that he or she has successfully completed a three-month training course conducted by Customs. Currently, more than a sufficient number of licensed brokers, about 1,500 in Jakarta alone, are available to meet the demands of the trade. As a result, the DGCE has not held recent training, nor does it plan to in the immediate future.

A set of sanctions Customs is to take against licensed brokers for improper behavior is outlined in the Customs Law, with criminal prosecution for high value fraudulent actions instituted in 1994. Customs appears to use its sanctions authority effectively to promote professionalism within the ranks. Several brokers reportedly are currently serving jail time for fraudulent actions.

The partnership and good working relationship between Customs and Customs brokers benefits both parties. Customs routinely sends proposed changes to procedures and policy to the National Association of Freight Forwarders, the forum through which Customs brokers comment on such changes.

Freight forwarders are responsible for arranging the movement of goods for their client. Depending on the terms of sale, this can include trucking from the factory, warehousing, stuffing and unloading containers, and sea transport to the importer's premises (door-to-door movements). The number of Indonesia freight forwarders range from 1,350 to 2,000, according to those firms registered with GAFEKSI, the Indonesian Freight Forwarders Association. A company must secure a business license for freight forwarding from the Ministry of Trade, a designation that also permits the company to conduct Customs clearance provided the company employs at least one certified broker. Most firms are small, although a limited number are partnered with internationally recognized providers. Mid-to-large size companies handle about 300 containers per month and generally offer a full range of service, including transport, warehousing and clearance.

There is an oversupply of freight forwarders and many are considered to be unprofessional and charge too much for their services. Few use modern IT integrated logistical systems to control transport involving multiple parties. Paper or stand-alone IT systems are the dominant business method used to communicate along the transport chain. Charges for the more reputable firms, including freight forwarding, Customs clearance, and informal payments on a full container, range from $55 to $80 import (green lane) and $40 to $45 for an export shipment. Informal payments constitute about half of this charge.

Bonded warehouses. Indonesia law does not provide for the long-term storage of imported merchandise to delay duty payment until time of withdrawal. If goods are not entered and duty paid within three months of import, they are considered abandoned and sold by Customs at public auction.

Many freight forwarders operate common warehouses where goods can be stored temporarily prior to clearance. Many are located within the port and function primarily as consolidated freight stations, moving merchandise into and out of containers. Sufficient facilities are available and charges are reasonable. The Ministry of Transport, through consultation with users, issues tariffs for activities within the port such as warehousing and freight consolidation. A ministerial decree of May 2007 lowered some of the fees in this sector.

Special Economic Zones. Indonesia created special economic zones, called bonded zones and industrial parks, in 1968. The first one in operation was located five kilometers from Tanjung Priok and operated by a state owned enterprise, Kawasan Burikat Nusantara (KBN). Batam opened its industrial zone soon after (1971). These operations allows firms to set up manufacturing operations designed principally for export, in which the imported components, the exported goods, and the majority of the machinery and equipment needed for the operation are exempted form import/export taxes and value-added tax. Firms operating in these zones can have 100 percent foreign investment and are granted liberal tax holidays.

Currently there are seven public bonded zones and industrial estates, all operated by state-owned enterprises. Additionally there are more than 1,000 private bonded zones that include solely the operations of the owner-operator. The largest public bonded zone is the original facility adjacent to Tanjung Priok, which currently has 146 users, mostly garment and furniture producers from South Korea that export to the United States.

The Ministry of Finance licenses and regulates the operators and users with intensive DGCE oversight. A Customs officer is stationed on-site and operates out of space the operator provides. Adequate security must be in place to prevent illegal leakage of the goods into the domestic market. Current law allows a limited percentage of production to enter the domestic market upon payment of all taxes and duties. The Ministry of Finance performs yearly audits of the firms in the zones.

From 1986 to 1996, the procedures and benefits of operating in a bonded zone were clear, streamlined, and predictable to the user. The companies operating the zones were authorized to serve as a one-stop service shop for the investor. Operators could secure all required licenses and permits and execute import/export documentation and clearances. Foreign investment grew, particularly in Batam, where Singaporean investors reaped significant benefits.

New legal requirements implemented in 2000 repealed some of the tax benefits, increased the role of Customs in the zones, decentralized the authority previously granted to the operator to serve as a one-stop shop for the user, and transferred government oversight from the Ministry of Trade to the Ministry of Finance. The result has been slower new investment and the departure of many firms. In 2007, 14 firms have left the zone at Tanjung Priok and six Singapore firms, mainly engaged in electronics, have left Batam for either Malaysia or Vietnam.

Illegal diversion from the zones into the domestic market is a problem. Although export containers from the zones are packed under Customs supervision and sealed prior to departure, Customs has been ineffective in ensuring delivery and export of the shipment. The textile sector believes a significant portion of the garments on the black market come from this source.

Indonesia's lack of success in attracting new investment while maintaining its current level of economic zone activity is in contrast to many of its regional counterparts. In 2006 no foreign manufacturing-related enterprises entered Indonesia. Reasons for this include:

- **Lack of clear and consistent rules regarding zone operation.** Included in this problem is the uncertainty of tax liabilities due to inconsistent and non-transparent tax collection practices, as well as increased taxes on users. Income tax is now imposed on investors.

Duty and taxes are now assessed on movements of products between bonded zones in Batam, despite the fact that the entire island has been declared an export-processing zone.

- **Lack of clear authority within government for problem resolution.** The absence of clear direction has increased frustrations among users who attempt to resolve operational issues. Transfer of oversight from the Ministry of Trade to the Ministry of Finance has led officials to view users as opportunities for increased revenue rather than as an engine for national economic growth. No national agency has taken on the role of promoting this investment opportunity abroad, unlike the aggressive marketing campaigns pursued in many countries of the region. Attempts by the regional authorities to set up bonded zones have failed due to lack of capital to provide the needed infrastructure and promotion.
- **Bureaucracy.** The regulatory burden includes requirements imposed on users regarding permits and licenses, which are issued by different departments.
- **Restrictive labor laws.** As detailed in this report's chapter on Foreign Direct Investment, Indonesia's labor regime hampers the flexibility foreign investors require to adjust its labor force in accordance with fluctuating demand. Termination of employees is a cumbersome process requiring government approval. Severance pay in Indonesia is among the highest in the world and pension liability for employers is onerous. This creates increased costs of production and a reluctance to hire a permanent work force.

The government appears to recognize its lack of success compared to its neighbors in promoting economic zones as an engine for economic growth. It has simplified procedures for creation of these facilities. Under a pilot project, Batam, is instituting a one-stop shop for issuance of permits and licenses. If successful, it will be expanded to other locations at the end of 2007. Assessments are underway to determine where new economic zones should be established.

With the slow pace of reform and the failure to address investor concerns about predictability and transparency at the implementation level, growth in economic zones will continue to be limited. As an example, the legal framework for the establishment of Special Economic Zones on the Riau islands agreed to in June 2006 under the Indonesia-Singapore Framework Agreement on Economic Cooperation has not yet been established.

Trade associations/ public private partnership. The concept of a professional business association that assists its members in improving its business practices and serves as a collective voice to influence public policy is not an accepted principle within Indonesia. Most businesses have a very individualistic approach to problem resolution and growth, and want to keep business data, problems, and strengths confidential for fear of losing any competitive advantage. Firms are therefore reluctant to fully participate within an association framework. They are only beginning to think in terms of global issues and long-term business strategies that are often the focus for trade sector groups. Because firms often see no benefits of belonging to an association, membership can be low and dues payments are often not submitted, thus limiting an association's ability to provide needed services.

There are exceptions to this prevailing mentality, and some sector groups, such as those representing textiles, steel, and agriculture, help resolve problems for their constituencies. Although this approach is fairly effective in resolving day-to-day problems, issues of a wider scope, such as simplification of procedures and elimination of illegal fees, remain difficult to

solve. Problems remain when action is required of multiple ministries, despite the existence of a ministry responsible for multi-agency coordination.

However, the outlook for associations is not entirely bleak. The **Indonesian Textile Association** (API), is a private non-profit association whose membership includes 1,056 of the total 2,600 textile producers. Through its 14 regional offices, it serves as an effective voice for its membership. Advocacy through trade associations diminishes the potential for retribution toward a particular complainant. In 2006, API successfully lobbied for a rollback in higher electricity rates for its members. Its yearly study on the state of the industry is well prepared and documents the problems of the sector. Unfortunately, limited funds inhibit API's ability to conduct needed training for its members in areas such as productivity improvement and industry trends.

Another association that is unique to Indonesia and has the potential to drive change is the **Association of Priority Lane Companies** (APJP). Forty-seven out of the 96 major importers certified by Customs for this expedited treatment are members. Although originally formed to partner with Customs in implementation and further refinement of the priority lane program, APJP is now starting to address other problems that slow the movement of their containers. Because APJP contributes significantly to meeting domestic market demands, employs a large national labor force, and is composed of major players in the international arena, it could be an effective agent of change.

The **Indonesian Chamber of Commerce** (KADIN), is well connected politically and influences public policy. However, often KADIN has difficulty balancing the protectionist demands of some of its members with those that seek more competitive market conditions and trade expansion. An active partnership exists between the foreign chambers and KADIN through the **International Business Chamber**, which meets weekly and serves as a unified voice in addressing concerns. KADIN is decentralized; businesses join at the provincial level, which then selects the leadership of the national chamber. At times, the process results in national leadership with more political than actual business background and experience. Much of the business community views the current structure as an impediment to addressing its collective interests effectively.

A degree of **partnership** exists between government and the trade community. The appropriate trade associations review draft legislation and regulations pertaining to business. The government considers comments are considered and sometimes incorporates them into the issuance. Government leaders continue to state their desire to reduce costs and simplify procedures. Despite success in containing some port-related costs, new regulations often only add to the existing complexity of doing business. As an example, in an environmental effort to protect its forests, Indonesia instituted cumbersome, costly, and multiple permits and licenses to export wood and wood products. A more simplified integrated system would have been preferable.

On the occasions where industry has approached the government to urge a change in policy or procedures that it deems detrimental, the government has generally failed to respond. Issues of reform that require multi-ministerial cooperation are the most difficult to achieve. Although there is a designated ministry, the **Coordinating Ministry of Economy**, designed specifically to resolve and promote such initiatives, remedies are few. Some international traders interpret this

as a lack of government commitment at the working level to improve the business climate. In this environment, a more effective partnership between the public agencies and private business is difficult to achieve.

Social Dynamics

Indonesia is becoming less competitive internationally in relation to its neighbors. To date, promulgation of improved investment and business practices, including a streamlined import/export process and upgrade of the supporting infrastructure (which many of its neighbors have initiated) is not ranked as a high government priority. With the largest economy in the region, the legislative and executive branches are focused principally on the regulation and growth of domestic trade. The result is the adoption of policies that protect the domestic producers from competition rather than opening markets to foreign investment. Accordingly, within the government there is limited demand for the changes needed to spur international trade. The trade community's belief that the government lacks a commitment to address the problems it faces is well founded.

Additionally, no significant, organized movement to address critical issues of trade facilitation is apparent within the trade community. Many engaged in the import/export trade have found a way to work within the system despite the bureaucratic red tape and unofficial fees required, and are reluctant to be subject to a more transparent, simplified process. Fear of the unknown and how they will benefit from change impedes the call to reform. Additionally, many in the community may be complicit in the rampant fraud and smuggling endemic to Indonesia.

However, there are some influential **voices for improvement.** Well regarded, knowledgeable professionals now head several key trade related ministries (Trade and Finance, in particular), which are critical for the creation of an improved climate for foreign investment, for simplification and transparency in the import/export process, and for the reduction of corrupt practices within the border agencies. Likewise, the new Director General of the DGCE enjoys an excellent reputation. These individuals have been met with resistance within their ranks, and expectations regarding reform have diminished in the international trade community. Likewise, it is unclear whether the successes will significantly improve practices at the working level. There are few rewards within the current government bureaucratic process for mid-level officials responsible who execute reform measures, most of which would reduce corruption opportunities for the majority of their co-workers. One noted exception is that Customs officers executing the Priority Lane process receive higher wages than their counterparts.

A limited number of reformers exist in the **legislature.** These reformers are aware of the issues confronting the business community and are trying to support efforts by the Ministry of Finance to modernize the Customs Service. Some legislators considered passage of the new Customs Law of 2006 as an essential step in this process, although many believe that the new law leans too heavily toward the authority of Customs rather than achieving a balance with the rights of the private sector.

The major **newspapers** in both English and Bahasa freely expose government polices and actions that impede economic growth. They are openly critical and demand changes to address identified wrongdoings or weaknesses and serve as an effective watchdog over government misconduct. Trade associations use the media effectively to expose issues where government

action is inadequate. Such exposure can result in an attempt by the appropriate ministry to discuss the issue.

Recommendations

- Expand the Priority Line program that allows compliant large importers to speed their goods through Customs processes. This approach should continue while the major reforms and programs proceed. Numerous countries have adopted this approach to allow their limited resources to focus on high-risk shipments while providing tangible benefits to legitimate businesses. Treating these companies as accounts, appointing Customs-employed account managers, and instituting a special set of compliance, risk criteria, and post-release audit for select companies could allow many legitimate companies true expedited service and separate their shipments from the flow of riskier imports.
- Consider adding a problem resolution capacity to the planned special Customs office for priority client coordination. Client Coordinators could act as the focal points to resolve Customs issues clients encounter at the ports. This function has been a very popular and effective aspect of Egypt's Gold Card program, and could prove similarly effective in Indonesia.
- Support efforts by the Association of Priority Lane Companies (APJT) to streamline operations at the port of Tanjunk Priok. These include assisting APJT in analysis of current environment, making available to them regional best practices, and garnering the support of other trade associations to promote adoption of recommendations.
- Procure a modern, automated Customs transaction system such as ASYCUDA World, and ensure that the modules that provide manifest accountability, selectivity, and improved collections are faithfully implemented along with changes in the underlying business processes. Additionally, Direct Trader Input (DTI) should be mandated, or at least encouraged. Disincentives such as charging a processing fee for DTI should be discontinued. A true expedited service should be offered as an incentive for DTI. A new system would also allow for better risk management.
- Consider acceding to the WTO's Revised Kyoto Convention (RKC). A gap analysis between the DGCE Customs Law and business procedures with those of the RKC should be undertaken. This convention reflects the current economic and technological changes necessary for a modern Customs administration that conforms to international standards and practices. The RKC also incorporates best practices of member administrations. The RKC is an excellent means for facilitating trade, ensuring economic growth, and improving the security of the international trade system. Such an effort is now underway by the Bureau of Customs in the Philippines.[83] Reform efforts of the DGCE would be greatly enhanced by such an effort.
- Use Post-Release Audit to identify importers that are compliant and knowledgeable about Customs and Other Control Authority laws and regulations, and then put their shipments into a an expedited service.

[83] *See* www.rkcphil.net.

- Reduce human contact and the need for Customs intervention between the Customs officer and the Customs broker by excluding the private sector from the DGCE official entry processing units. Brokers should have a designated box for submission of their documents that should be time- and date-stamped. They should retain a copy of the stamped entry as evidence of submission. Final documents needed by the traders should be placed in a single area for pick up.
- Review new Customs legislation and the yet-unpublished executive regulations to measure the consequences of the reform on the honest trader. There are reasonable alternatives to tightening controls on an operation while maintaining a balance on facilitation. Draconian penalties do not ensure a compliant trading community.
- Enhance anti-smuggling efforts and develop a comprehensive strategy with trade, its associations, public officials, and international experts. Other countries have successfully addressed these issues through such coordinated efforts.
- Provide human resource training in modern business practices for port and transport companies. These would include promulgation of a modern service mentality and management and adoption of integrated IT services.
- Prepare a new strategic plan for DGCE that includes an implementation plan incorporated into the overall document. A special group or reform unit should be created to implement and monitor the plan.
- Place special emphasis on integrating the border operations of the DGCE with the other control authorities, especially health and agriculture. The SAD and procedures from the upcoming National Single Window test should be expanded to all of Indonesia. Other control authorities should have access to the DGCE automated system, the ability to place and remove holds, and the ability to use certain functions, such as the selectivity and collections functions.
- Review and update the current DGCE website. Transparency and better public service would be enhanced by the addition of:
  - Pertinent laws, regulations, and directives, either existing or approved
  - Procedures for joining programs such as Priority Lane
  - Contact information for problem resolutions
  - Customs tariff and classification guides
  - Links to other Indonesian Control Authority websites
  - Links to International Customs websites
  - DGCE rulings
  - Audit procedures
  - Schedules of legitimate fees
  - Broker’s notices
  - Other pertinent news, data or information.

- Provide assistance to the DGCE to support its ongoing efforts to improve the efficiency of the agency and reduce corruption. Donor assistance (particularly in the area of Customs automation and integration of other border agency activities), which is currently not flowing to the agency, should be undertaken with a well defined scope of work and anticipated results required for continued funding. Today's assistance, generally in the form of anti-terrorism efforts, could be used to establish the necessary foundation. These efforts would lend international support and continued pressure for modernization and reform of the agency.
- Adopt a one-stop port service office. Streamline the process as much a possible and then establish an office where representatives of all the remaining functions can be co-located to complete all required documentation. Elimination of ad hoc obstacles should be a priority. Visits to other, more efficient ASEAN port locations would be beneficial when developing this project.
- Offer incentives to reward public officers who effectively implement and support meaningful reform measures. Review of the program regarding Customs and Priority Lane customers could be a stating point.
- Expedite the development of the port of Bojonegara as an alternative to Tanjunk Priok. The contract requirements for privatization must clearly demand the delivery of modern port efficiency standards and an integrated IT management system. Allow the operator to employee a professional work force.
- Improve security of movements out of economic zones to the ports by implementing a tracking system that includes arrival and departure actions to close a file, condition of seals on containers, and travel time limits. This would be a major step in reducing the amount of bonded goods that enter the Indonesian black market.
- Designate a clear authority within the ports for overall security and define the role of all participants. This authority must be vested with authority over the other involved agencies to ensure compliance with requirements and adequate leadership.

FLOW OF MONEY

Introduction

In Indonesia, cross-border transactions reflect a significant amount of monetary exchange. Over $186.4 billion in goods and services were traded in 2006. Net FDI inflows amounted to $7.5 billion in 2006, down from $8.5 billion in 2005. Trade financing is fundamental to this flow of international commerce. A sophisticated set of mechanisms and tools has been created to facilitate the exchange of goods and services internationally. Many trade finance products and services, prior to the Asian financial crisis in 1997–1998, were increasingly available from a network of financial service providers in Indonesia.

In the mid 1990s, the Indonesia banking sector, including both private and state-owned institutions, possessed an established network of international correspondent relationships and traditional instruments to support trade flows. Hedging instruments, though widely used around the globe, were often ignored in Indonesia. Indonesian importers and exporters had access to a wide variety of trade-financing options, including import letters of credit, pre-shipment working capital loans, and post-shipment refinancing. Strong inter-bank lines of credit supported these instruments. Indonesian banks and corporations also had access to a large number of direct and derivative financial instruments designed to help cover foreign exchange risk, but these were often not used either. With the rupiah under a managed float, both borrowers and lenders believed that hedging their exposure was unnecessary.

Although access to trade-finance products was relatively advanced for the region in the years leading up to the financial crisis of 1997–1998, two factors still constrained trade financing in Indonesia. First, the banking sector was the primary source of trade finance and costs were relatively high. This often priced many small and medium-size enterprises out of the market. Second, Indonesia had developed few of the non-bank financial instruments for financing trade that are available in other, more developed countries.

The crisis of 1997–1998 damaged the development of Indonesia's trade finance system. Many of the financial products that had previously been available were either viewed as too risky or too expensive by banks and other financial institutions in the wake of the crisis. In addition, the cost of financing was prohibitive and there was a lack of non-bank financial instruments.

In a modern economy, adequate access to credit and foreign exchange are essential to efficient and secure trade. Poor access to credit for domestic traders impedes start-ups and slows expansion. Indonesian laws and public and private institutions generally support both access to credit and trade-related money flows. Basic trade finance products are becoming more widely available to traders, although the availability of these products has not returned to pre-crisis levels. Foreign currency exchange is also broadly available, and all traders fine it fairly easily to exchange.

Despite this progress, Indonesia must deepen its bank and non-bank trade related financial instruments. If more institutions offered these products, inter-institution competition would reduce their cost to trade financiers and could dramatically increase usage among small and

medium-size enterprises. It is equally as important to increase the volume of long-term credits that are very difficult to find due to market volatility and poor corporate balance sheets.

Legal Framework

In Indonesia, a legal framework designed to ensure efficiency and security of trade-related financial flows (e.g., letters of credit, documentary collection, currency exchange) is generally in place. The framework has long conformed to the Trade Finance Guidelines of the International Chamber of Commerce and the 2000 Uniform Customs and Practice for Documentary Credits.

The abandonment of a pegged exchange rate regime in 1987 for a managed float has allowed for a more unencumbered flow of capital despite small but regular devaluations of the rupiah relative to the dollar. Since 1997, the rupiah has been allowed to float freely. The lack of existing regulatory barriers to cross-border flow of funds supports the free flow of capital. There are no significant legal restrictions to the free flow of legitimate business and tourist travelers or to the flow of goods and services into and out of Indonesia.

The Indonesian legal framework supports trade-related payments in the form of wire transfers, commercial letters of credit, standby letters of credit, documentary collections, and open accounts.

Laws to enable the oversight of financial transactions are generally in place. The Indonesian legal framework requires manifest declaration for cross-border movements of currency above 100 million rupiah (approximately $10,000). This figure compares relatively favorably to other countries in the region – the Philippines, for example, limit cross-border movement of cash to just over $200 – but many traders would argue that the limit is too low. Moreover, organizations providing financial services are required to register and operate under licenses issued by a competent authority, and are subject to financial crimes reporting regulations. In addition, the penalties for violation are significant enough to compel performance; however, weaknesses in the investigative capabilities and judicial system reduce the incentive for compliance. The dispute resolution system's consistent lack of action, and not the legal framework itself, is more often the driving factor in cases of non-compliance.

Although the legal framework does not prevent Bank Ekspor Indonesia (BEI) from providing export credit, as a result of the fact that legislation allowing BEI to transform into Indonesia Exim Bank is still stalled in the House of Representatives, this institution is not able to adequately expand its activities broadly enough to facilitate trade for small and medium-size enterprises.

An additional barrier to trade on a micro level is the inability of commercial banks and currency exchanges to accept dollars that are worn, tattered, or do not have a specific serial number found acceptable. Bills that are acceptable in other countries in the world are either refused or exchanged at a disadvantaged rate in Indonesia, discouraging small-scale investors and customers from doing business in dollars in Indonesia.

Implementing Institutions

There are currently 131 **banks** operating in Indonesia, of which four are owned by the state (BNI, Bank Mandiri, BTN, and BRI). These four banks control 40 percent of the assets in the

banking system. The top 10 banks in the sector control 80 percent of assets, and foreign investors control 41 of the 131 banks.

Although the figures above do not reflect a particularly diversified banking sector, significant progress has been made in this area since the crisis of 1997-98. The four state-owned banks cited above already represent a drastic reduction from the 13 banks nationalized in the aftermath of the crisis. The sale of controlling shares of Bank Permata, Lippo Bank, and Bank Internasional Indonesia exemplify the government's recognition of this problem as well as their commitment to dynamic action in this area. Bank Indonesia (BI) is also currently considering the privatization of three of the four of the remaining state-owned banks listed above.

In July 2005, BI released regulation 7/15/PBI/2005 and circular 7/48/DPNP to address the surplus of small, unqualified private banks. The impetus for these regulations was the need for guidance on the consolidation process critical to the future health of the Indonesian banking sector. Under these regulations, banks holding Rp80 billion by 2007 and Rp100 billion by 2010, in addition to meeting specific requirements for capital adequacy, loan growth, and return on assets, are categorized as "anchor" banks and as such are permitted to acquire other banks. Banks not meeting these requirements are not only not permitted to acquire other banks, but also unable to participate in foreign-exchange trades or to conduct business outside of their own province, encouraging them to merge with one of the "anchor" banks. Although only 15 banks were expected to fall below this threshold in 2007, the criteria will become increasingly difficult to meet, and BI ultimately intends to use this process to reduce the total number of banks to 60-70.

Bank credit has also significantly increased since the crisis of 1997–1998, as have the breadth of types of assets held and financial products banks offer. In 2005, BI reports that outstanding credits increased 22.7 percent over the previous year, and in 2004 the same figure was reported at 24.7 percent. The Loan-Deposit Ratio (LDR) increased from 61.8 percent to 64.7 percent over the one-year period ending in January 2006. BI reduced the weighting of risk for loans to small businesses from 100 percent to 85 percent in order to boost bank credits to this group.

The figures presented above suggest a lack of competition and lack of real depth in the financial sector. This deficiency is already being targeted for legal reform; however, significant progress in inter-bank competition has not happened.

The increase in credits over the past few years similarly does not accurately reflect progress made in the banking system. BI statistics indicate that this increase falls disproportionately in the consumer loan category and that, due to interest rate volatility and high indebtedness among these businesses, banks remain wary of providing loans to small and medium-size enterprises. As a result of this bias, many Indonesian importers and exporters have no choice but to use their own cash flows to finance transactions, creating a costly inefficiency in the market.

More critical is the shortage of banks offering trade-related financial products. Prior to the crisis of 1997–1998, products such as private placements, financial leasing, commercial paper and factoring, and structured finance were beginning to take hold in Indonesia. Since the crisis, however, activity in these instruments has been slow to return due to a general feeling among investors of skepticism and apprehension. Until these products are offered widely across the sector, their prices will remain uncompetitive and will hamper importers' and exporters' ability

to participate profitably in the global market. This lack of competitive financing will also discourage foreign investors from injecting capital into Indonesian companies dependent on cost-effective imports and exports for the success of their business.

Bank Indonesia, the Indonesian central bank, was granted independent status by the Central Bank Law of May 1999 (Central Bank Act No. 23/1999), allowing it to operate independently of the Ministry of Finance and other external forces. Prior to this law, the **Ministry of Finance** heavily influenced monetary policy. The Ministry now focuses exclusively on fiscal policy and related factors, such as investment insurance and development finance.

While the central bank's main role is to determine Indonesia's monetary policy, it also acts as the main regulatory and supervisory body to both state-owned and private banks. As this role detracts from its main function, the government has long been working toward establishing a regulatory and supervisory agency to monitor the financial system as a whole. The **Financial Services Authority** (FSA) will concentrate on ensuring that the banking sector operates appropriately and efficiently in order to encourage economic growth and protects the interests of the consumer. It will have the power to enforce laws, and as a result the banking sector will benefit from the presence of a more specialized watchdog. Initially this agency was to become operational by the beginning of 2003; however, BI has revised its target operational date to December 2010.

Since the financial crisis of 1997–1998, BI has been relatively effective in maintaining a stable exchange rate and stemming inflationary trends despite its occasional efforts to prop up the rupiah by selling dollars. In August 2005, there was a run on the rupiah and BI took measures to quell the outflow, including a 126 percent fuel price hike. The resulting increase in inflation and interest rates has made monetary policy prescriptions difficult for BI, and a return to the progress the financial sector had made in the use of more complicated instruments has been slow. However, the central bank has been able to maintain credibility among both banks and the population.

In spite of the crisis in 1997–1998 and the run on the currency in 2005, BI encourages capital to flow freely into and out of Indonesia. All capital controls have been removed and foreign investment is generally encouraged. No restrictions apply on repatriation of capital or remittances. Currency exchange is available not only at the central bank but also at commercial banks, ATMs (from foreign currency accounts into rupiah), hotels, and independent currency exchanges. In order to mitigate the speculative risk that the free flow of capital invites, BI has amassed $50.11 billion in reserves – enough to cover more than six months of imports – and works to create a fertile investment atmosphere.

Although BI has been able to maintain a stable exchange rate and a stable investment climate on the whole, it has not been able to improve the long-term credit outlook for Indonesia. This is due in significant part to other weaknesses in the economy, including fiscal policy, political conditions, and a remaining perception of high levels of corruption throughout the public and private sectors. Investors are still hesitant to commit to Indonesia as a long-term destination for their capital.

Supporting Institutions

Export Credit Agency. Bank Ekspor Indonesia (BEI) was founded in 1999 in order to facilitate Indonesian exports by providing financing and guarantees that had previously only been obtainable from the central bank. BEI adds significant value to Indonesia's financial sector by providing a knowledgeable staff able to offer training and increase awareness about export finance as well as well-structured financial products specifically designed to suit exporters' needs. As one of only 10 banks engaged in export finance – three of them state-owned – and the only one created solely to facilitate trade finance, BEI is uniquely positioned to drive the niche market in Indonesian trade financing.

Bank Ekspor Indonesia (BEI) has a solid lending framework. It provides loans at interest rates linked to commercial bank rates but provides services that are generally unavailable at these banks. BEI offers exporters flexibility by providing this financing in either rupiah or dollars, and by allowing exporters a repayment period of up to 360 days. For loans that are guaranteed by BEI, the rate is determined by the lending bank's prime lending rate plus a margin. A guarantee fee (charged by BEI) and a confirming fee (charged by the primary lender) are also factored into these rates.

BEI also acts as an advisory body to exporters. The President Commissioner, Mukhlis Rasyid, cites "enhancing human capital and competencies" as a top priority going forward in BEI's 2006 Annual Report. By creating an institution separate from BI, both exporters and their creditors share the common top priority of increasing Indonesian exports, making an export advisory department a necessary strategic asset.

With a recorded growth of 16.8 percent for 2006 and an increased net profit of 22.8 percent over 2005, BEI operates profitably. Despite its profitability, its balance sheet does not allow sufficient flexibility to provide credit for all interested exporters. BEI is currently only able to serve about 50 companies in Indonesia and has to refuse most small and medium-size enterprise applicants because it does not have a sufficient portfolio to support the risk serving these companies entails. The companies most in need of export finance are generally smaller Indonesian exporters that are highly indebted and thus also unable to find credit elsewhere.

Import credit. Import credit is almost non-existent as a result of foreign exchange volatility and high interest rates. Some degree of guarantee is available in the form of internationally recognized stand-by letters of credit provided by foreign exchange banks and their international branches. However, in order to stimulate this counterpart market, more credit needs to be made available.

Since its establishment in 1999, BEI has recognized this gap in the financial offerings of the Indonesian banking sector. It is currently awaiting the Indonesian House of Representatives' approval on legislation allowing it to be transformed into the Indonesia Exim Bank (IEB). This legislation stems from a point contained in the letter of intent the Indonesian Government and the IMF signed in 1998. It has been tabled multiple times due to its low priority relative to other pending measures, but its approval would go help afford BEI the ability to raise additional cost-effective capital and manage more risk effectively. Accordingly, this would allow BEI to provide both import and export credit to small and medium-size enterprises currently unable to procure export and import loans.

Social Dynamics

The banking crisis in the late 1990s was a significant setback for the entire Indonesian financial system. The crisis particularly hurt trade, as diminished appetites for risk and increased scrutiny of bank balance sheets all but eliminated the private sector's involvement in providing financial products and services to facilitate trade. Ten years later, the sector has made considerable progress toward constructing a sound regulatory environment and a supervisory framework that raises the confidence of both domestic and foreign investors. This has led to the growth in the financial sector's ability to facilitate trade through many of the internationally recognized mechanisms. But the providers are few, the costs are high, and market coverage is minimal. Bolstering trade finance is not a priority of the government and not a typical media topic. Overall, Indonesia is on a path toward developing a more sophisticated and diversified financial system that will bring improved access to longer term capital, increased access for small and medium-size businesses to credit, and product and service innovations that meet the needs of businesses conducting international trade.

Recommendations

- **Deepen the offerings of financial sector participants engaged in providing trade finance.** Increasing the types and availability of trade-related products as well as the quality of existing products would enable currently marginalized small and medium-size businesses to more efficiently and competitively engage in currently existing trade opportunities.
- **Pass legislation allowing the transformation of BEI, Indonesia's export credit agency, into an official Exim Bank of Indonesia.** This agency would provide Indonesia's smaller exporters and importers with a level of support not available under the current system, allowing them to compete more effectively in the global market.
- **Encourage investors to migrate into long-term credits**. Increasing the volume of long-term credits in Indonesia would help stabilize the Indonesian economy and build investor confidence in the Indonesian banking sector. Because investor confidence is also required to stimulate movement toward long-term credits, both the government and the banking sector as a whole must actively promote long-term credits through continued development of the capital markets.
- **Encourage improved public and private sector coordination around trade finance issues.** There are incentives on both sides to advance the relatively anemic growth of the trade finance regime. The government and the private sector should more consistently communicate about the range of barriers that hinder the development of trade finance.

FLOW OF PEOPLE

Introduction

The efficiency and security of trade-related flows of people, both in and out of a country as well as within a country, are important to facilitate international and domestic business. More specifically, the ability for legitimate importers, exporters, investors, and their related facilitators (e.g., attorneys, accountants, business development professionals) to move across borders and through a country efficiently as they trade their goods and services is necessary to ensure the smooth flow of commerce. However, it is also important for countries to provide security at border crossings and to protect such businesspersons and others. They must strike a balance between the needs of business and the needs of national security.

As with the trade-related flows of money, in a well-functioning trading system, the movement of short-term visitors is often a minor administrative detail in the trading scheme. Yet in some countries with overly restrictive security policies, entry into and movement within a country creates logistical and financial obstacles for legitimate traders, and can act as a deterrent to trade. On the other hand, flows of people for illicit purposes can lead to instability in the trading system as a whole. Therefore, security policies and procedures are necessary to prevent entry of persons, such as terrorists and other criminals, who pose a danger to society.

Overall, the state of immigration flows in, out, and through Indonesia is adequate to meet current business needs. Generally, the legal framework is in line with international standards. However, immigration-related institutions and processes remain needlessly cumbersome and time-consuming. Subsequent to the troubles in East Timor of 1999 and the terrorist attacks in Bali of 2002, Indonesia made changes to those institutions and processes, and concern arose that travel in and out of Indonesia would slow considerably. In an effort to offset this possible consequence, the government responded by implementing a "visa on arrival" (VOA) process in which aliens from certain countries are not required to obtain a visa prior to entry into Indonesia. Reports are that this process has facilitated both short-term business and tourist travel. However, more remains to be done, such as with respect to supporting Indonesian migrant workers.

The average annual number of foreign visitor arrivals from 1996–2005 has been, on average, just under five million per year, with a high of 5.3 million in 2004 and a low of 4.6 million in 1998.

The number of immigrants to Indonesia has remained relatively constant, both by total number and by country of origin. The average annual number of foreign visitor arrivals from 1996-2005 has been, on average, just under five million per year, with a high of 5.3 million in 2004 and a low of 4.6 million in 1998. Since 2001, by country of origin, Singaporeans have been the largest group, consistently comprising 28–30 percent of total immigrants per year. The United States has provided a consistent annual average of three percent of the foreign entrants during that same period.[84]

[84] www.bps.go.id/sector/tourism/index.html.

Number of Foreign visitor Arrivals to Indonesia (selected countries)[85]						
Year	**Total**	**Singapore**	**Japan**	**Malaysia**	**United States**	**China**
2001	5,153,620	1,477,132	611,314	484,692	177,869	32,197
2002	5,033,400	1,447,315	620,722	475,163	160,982	36,685
2003	4,467,021	1,469,282	463,088	466,811	130,276	40,870
2004	5,321,165	1,644,717	615,720	622,541	153,268	50,856
2005	5,002,101	1,417,803	517,879	591,358	157,936	112,164

Legal Framework

The legal and regulatory framework supports trade-related immigration and provides the government with authority to ensure public order and security. The primary governing law for immigration is Law No. 9 of 1992 concerning Immigration Affairs (with various amendments), and it provides for entry and exit regulation for both aliens and Indonesian citizens, describes the roles of various actors in the immigration system, outlines acceptable forms of documentation, and establishes criminal acts and subsequent penalties for violations of immigration law. Various other laws form part of the immigration process, such as laws on criminal procedure and on labor affairs (with respect to work permits). A variety of government regulations and ministerial decrees are also part of the immigration system, as allowed for by the governing law.[86]

By law, every alien admitted to Indonesia is required to have an immigration affairs permit. The law provides for four categories of immigration affairs permits:

- Transit permits for those transiting through Indonesia
- Visa permits for those entering Indonesia for performance or government duties, tourism, socio-cultural activities, and business
- Limited residence permits
- Permanent residence permits.

With respect to tourism and business visa permits, the law allows for citizens from 63 countries to obtain a VOA at the port of entry for either short-term business or tourism, for either up to seven days (US$10) or 30 days (US$25).[87] In all cases the immigration officer may admit a person for less time at his or her discretion. Extension of the VOA can only be done by leaving the country and re-entering. Indonesia instituted this program in 2004 and has regularly updated the list of eligible countries. It has, in short, proved a successful means of easing the visa requirements for short term visitors.

[85] Id.

[86] See, e.g. Regulation no. 32 concerning Visa, Entry Permit and Immigration Permit. See also Decree of the Ministry of Justice dated 14 March 1995 concerning Transit Visa, Visiting Visa, Limited Stay Visa, Entry Permit and Immigration Permit (as amended).

[87] As long as the visa applicant's passport is valid a minimum of six months from the date of arrival.

For extended business visas and associated work permits, Indonesian law and regulation require a number of sometimes repetitive steps. In all cases, *ab initio,* company sponsorship is required. Next, for a company to employ foreigners and gain the necessary work permits, it must submit an Expatriate Placement Plan to receive an approving recommendation from either the Manpower Department (for a domestic company) or the Investment Board Department (for a foreign company). Once this step is complete the Immigration Office will issue a temporary telex visa; that is, send an approval electronically to the Indonesian embassy in the country where the applicant resides. The applicant then uses this visa to enter the country and begin the in-country process.

Shortly after entry, applicants are required to, *inter alia,* register with the local police (twice) and local immigration office. In addition, they (or their sponsoring company) must pay a $1,200 annual tax/fee[88], and, if the applicant is going to be traveling in the country, a traveling license. Lastly, an applicant receives his or her permanent work permit and multi-entry visa from the Immigration office. In addition, the applicant should maintain the 'Foreigner's Registration and Change' book, which tracks changes in immigration status, changes of address, marital status, etc. Failure to complete these steps can carry criminal penalties. The underlying government policy through all of this is to ensure that use of foreign workers is done selectively and to encourage the use and development of Indonesian expertise.

Implementing Institutions

A number of different government offices are involved in the immigration process: the Directorate General of Immigration of Indonesia, both in the region where the alien is to reside and at the federal level; the Immigration Attaché within each Indonesian Embassy or consulate; the Indonesian National Police; the head of the local district area; and the Ministry of Manpower and Transmigration. Each of the institutions has a clear mandate in law and regulation. Interviewees described Immigration officers and others involved in the process as competent and, for the most part, adequately trained. While the processes for completing visa applications (aside from visas on arrival) can be confusing because of the many steps and institutions, the time to complete those processes is generally reasonable. Optimally, if all documentation is order, the visa process can be completed in six weeks (three weeks out of country and three more after arrival), although it can take as long as a year if problems arise.

While avoiding violations of immigration law and policy is almost always a desired goal, various respondents mentioned this as being of particular importance in Indonesia. Indonesian authorities take very seriously violations of immigration status or regulation; even the most innocent violation could lead to fines and/or prison time. Perhaps the most common infraction is when an alien overstays his or her visa. Even a one-day overstay has reportedly led to an alien being 'blacklisted' (not allowed to enter Indonesia for a year or more) along with having to pay fines.

Official fees associated with immigration processes are seen as reasonable. However, it is common practice to pay additional facilitation fees, sometimes called "government processing fees." While unofficial in nature, the amounts are considered "fair and reasonable."

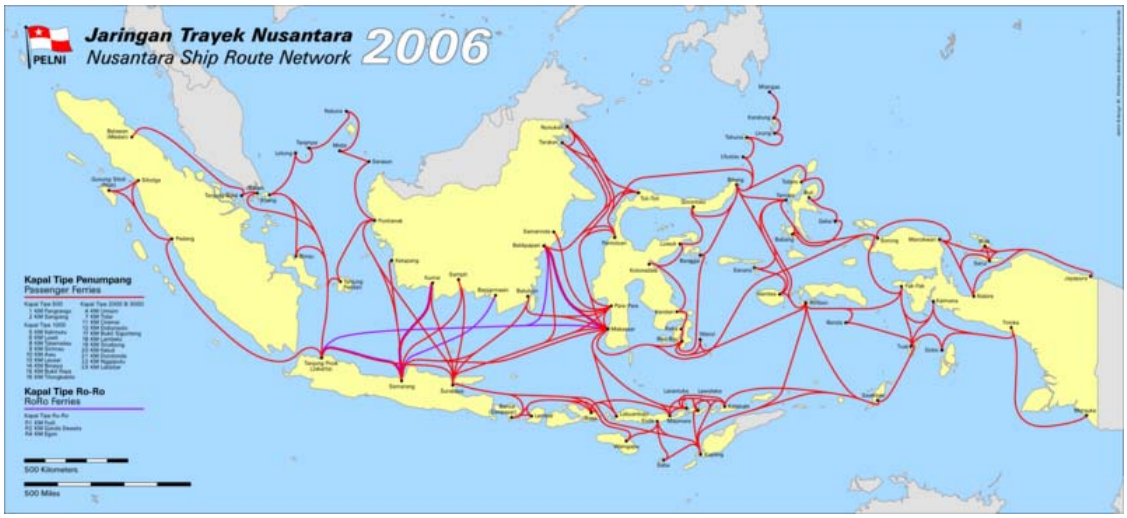
[88] This tax is to help pay for the training of Indonesians so that they may in the future be better able to compete for the kinds of positions for which foreign workers are at present needed.

Supporting Institutions

While **lawyers** are involved in immigration processes, a collection of professionals known as "**immigration agents**" assist the majority of immigrants to Indonesia. These individuals primarily specialize in assisting those entering the country for business and help foreigners navigate the often confusing processes. They provide a legitimate service and many respondents considered them vital to successful immigration as agents know, for example, how much and to whom to pay the necessary facilitation fees. Without such assistance the system reportedly can be untenable, and assistance within the Directorate General of Immigration is difficult to find.

With respect to the **infrastructure** related to immigration and the movement of people, the capacities are inconsistent. The main airports have adequate facilities to process persons seeking a visa on arrival, as well as other categories of immigrants. Intra-country air travel capacity is sufficient, with enough airlines and flights to meet current needs. With respect to roads, while there are shortcomings, particularly in rural areas, the Indonesian government (with international assistance) has recently undertaken a number of toll road infrastructure projects. Buses operate between major cities with regularity and other means of inexpensive travel are readily available in most locales. The railway system is run by the state through PT Kereta Api Indonesia, which is responsible for all rail transport, with passenger and freight service on all of the lines. The rail consists of four unconnected networks operating on the islands of Java and Sumatra, but given that Indonesia also has an extensive network of navigable waterways with passenger ships that make connections to more remote islands, this is not seen as a major shortcoming (see graphic). There is also a commuter railway in Jakarta.

Indonesian Shipping Routes



Source: Pelni Schifffahrtsnetz, 2006

Of particular concern in Indonesia is the support given to migrant workers. With the fourth largest population in the world, Indonesia is a source of hundreds of thousands of migrants who regularly seek employment abroad, primarily in Malaysia, Saudi Arabia, and Taiwan, but also

Singapore and elsewhere in the Middle East. The search for a better life has led to a dramatic rise in the number of irregular migrants as unemployment remains at approximately 13 percent.[89] Indonesians in Malaysia make up the largest irregular migration flow in Asia and globally are second only to Mexicans entering the United States.[90] While the money remitted by these migrant workers is not a significant percentage of the country's gross domestic product (GDP), it has increased significantly over time and is now approximately US$2 billion per year.[91] Historically, assistance to migrant workers, with respect to training, departure assistance, consular and other support while abroad, and re-entry has not been a well-supported priority. Migrant workers are often subjected to discrimination, extortion, and exploitation. Human trafficking, sexual abuse, and enslavement of migrant workers are also frequent. Upon return to Indonesia, many migrant workers are forced to pay bribes to re-enter the country.[92]

Remittance flows into Indonesia (in US$ millions)*[93]					
2000	2001	2002	2003	2004	2005
1,190	1,046	1,259	1,489	1,866	1,883

*This table reports officially recorded remittances. The true size of remittances, including unrecorded flows through formal and informal channels, is believed to be larger.

In 2004, Law no. 39 on the Placement and Protection of Indonesian Workers Abroad was passed in response to this situation. The law's aims are: to better manage migration flows, including improvement in the quality of workers and reductions in the number of illegal and undocumented workers; to establish institutional mechanisms for the training, placement, and protection of Indonesian migrant workers; and to better advocate on their behalf both domestically and abroad. The government is also taking steps to create in-country support systems in receiving countries, a more transparent mechanism for support services, improve data collection on migrant workers, and encourage cooperation between relevant government agencies. Numerous international organizations are also providing assistance in this regard.[94] As a result, private placement agencies that help Indonesians find work abroad are now required to provide assistance before, during, and after the worker is abroad. However, the actual quality of this support remains in question, as respondents stated that neither such agencies nor the government is sufficiently supportive of migrant workers, despite the new law.

[89] 2005 statistics represent the official employment rate at 10.3 percent, but local respondents report the rate as significantly higher. *See* The Economist, Economic and Financial Indicators (June 23, 2007) at 105.

[90] http://siteresources.worldbank.org/INTPROSPECTS/Resources/334934-1181678518183/Indonesia.pdf

[91] Id. This represents approximately 0.8 percent of GDP. This number represents official GDP measures, because of the nature or remittances this is likely lower than the actual amount.

[92] See, e.g., http://hrw.org/reports/2004/indonesia0704/7.htm#_Toc76201480 . See also http://pace.unipi.it/MakeItFair/migrant/Slavery%20continues%20to%20plague%20Indonesian%20migrant%20workers.php.

[93] http://siteresources.worldbank.org/INTPROSPECTS/Resources/334934-1181678518183/Indonesia.pdf.

[94] For example, the International Organization on Migration provides counseling, medical care, food and shelter to those who remain in Indonesia while other members of the family migrate, and assistance to those who wish to return home. All major international donor organizations, including USAID, provide assistance as well.

Social Dynamics

While there is broad recognition that efficient immigration flows—in and out of the country—is important to commerce, a degree of complacency with respect to immigration reform appears to exist within the Indonesian government. Nonetheless, a variety of private organizations, including those seeking greater support for migrant workers and improvements to the visa process, continue to advocate for change.

Recommendations

- Lessen the amount of paperwork and remove seemingly repetitive steps in the visa issuance process, such as having to register with the police twice.
- Create a one-stop window for the visa issuance process so that applicants are not required to make multiple trips to a variety of agencies, including the police, the immigration office, and the labor directorate.
- Develop online services for immigration, such as making more easily available all forms needed for visa issuance and allowing for the completion and submission of such forms online.
- Improve services for migrant workers, including: better recruitment, education and training prior to departure; better protections, including consular and legal services, while abroad; and greater support of migrant workers upon their return. Models of such efforts exist in the region, such as in the Philippines.
- Improve the government's capacity to employ appropriate strategies and technology to monitor and take action against irregular migration, and address other critical issues such as human trafficking and smuggling.

FINANCIAL CRIMES

Introduction

Over the past five years, Indonesia has aggressively strived toward constructing a more effective regime to combat money laundering and terrorist financing. The adoption of key legislation making these activities illegal has been the foundation of this multi-faceted effort. In 2002, following Indonesia's placement in 2001 on the list of Non-Cooperative Countries and Territories (NCCT), it began to build the legal framework and enforcement capabilities needed to reduce its vulnerability to becoming a haven for money laundering and terrorist financing.

Indonesia has made considerable progress in formulating and passing legislation that is generally consistent with international best practice, though weaknesses do remain. It has ratified many of the international conventions on money laundering and terrorist financing, is an active member in the Asia/Pacific Group (APG) on Money Laundering, and, through its Financial Intelligence Unit (FIU), is also a member of the Paris-based Egmont Group, an informal international organization of FIUs. In July 2006, the APG named Financial Transactions Reporting and Analysis Center (PPATK) Chairman Yunus Husein a co-chair of the regional Financial Action Task Force (FATF)-style organization for a two-year term.[95] International **donors**, most notably the Australians and the Americans, continue to provide technical support and guidance as the country bolsters its anti-money laundering legal system and improves the capacity of the various implementing agencies.

The illustration on the next page depicts the Indonesian network of government agencies and private sector stakeholders that work in partnership to combat money laundering and terrorist financing.[96] Indonesia's efforts involve reporting parties (providers of financial services), PPATK, financial regulatory and supervisory agencies, law enforcement and the judicial sector, the National Coordination Committee (NCC), and other relevant government institutions.

Ultimately, the effectiveness of Indonesia's anti-money laundering regime is a function of the ability of each party to fulfill its unique role in the system, and the coordination among the group as a whole. The failure of a single element of this network creates a gap that makes Indonesia vulnerable to these crimes.

Despite the progress in the past five years, there remains room for improvement. Combating money laundering and terrorist financing is a complex challenge involving multiple government agencies, the private sector, and international coordination. While the legislation that Indonesia has passed offers a solid foundation, the capacity of the agencies tasked with implementation of the mandate is crucial.

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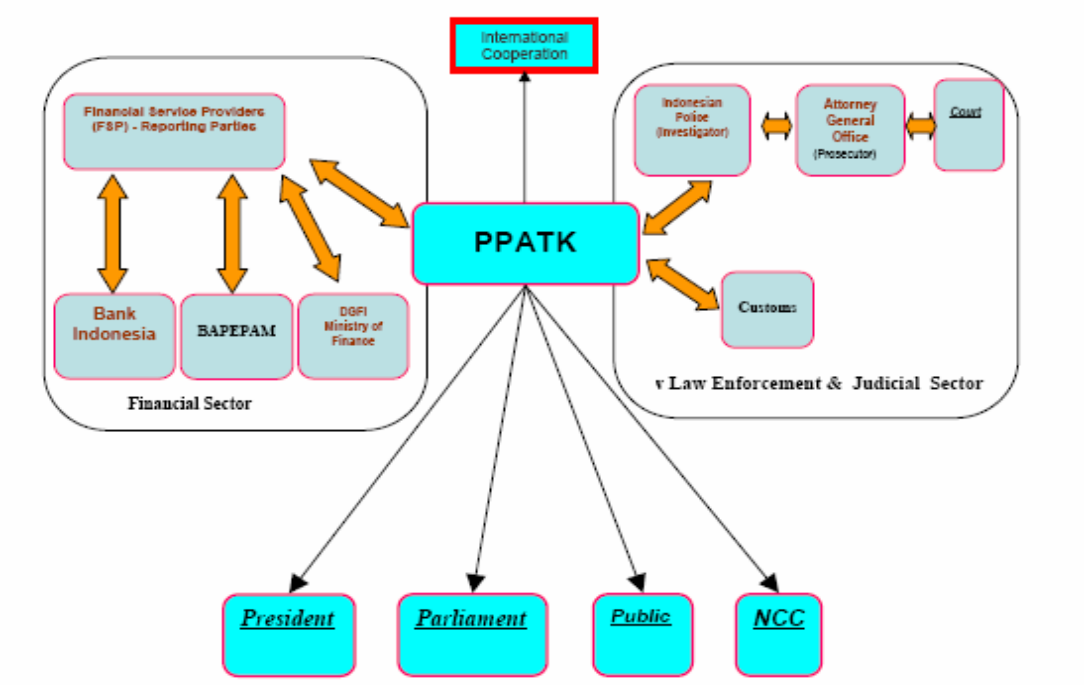
[95] Bureau for International Narcotics and Law Enforcement Affairs: Southeast Asia and the Pacific. International Narcotics Control Strategy Report, 2007. (For more details see http://www.shaps.hawaii.edu/drugs/incsr2007/incsr_2007_indonesia.html).

[96] Indonesian Anti Money Laundering Regime's Case Management Scheme. Diagram provided by the USAID Financial Crimes Prevention Project (FCPP) in Indonesia.



Legal Framework

Although Indonesia is not a major financial center or offshore financial haven, weak law enforcement and widespread corruption increase its overall susceptibility to criminal financial activity. Over the past few years, Indonesia has taken a number of concrete steps to bolster its legal framework; these steps are targeted at addressing the challenges of money laundering and terrorist financing. One of the most visible positive results is the removal, by the FATF, of Indonesia from the list of Non-Cooperative Countries and Territories (NCCT) on February 11, 2005, and subsequent special FATF monitoring on February 11, 2006.

In April 2002 Indonesia passed Law No. 15/2002 Concerning the Crime of Money Laundering, making money laundering a criminal offense. The legislation identified 15 predicate offenses related to money laundering including narcotics trafficking and most other major crimes. Additionally, the legislation established Indonesia's version of a Financial Intelligent Unit, *Pusat Pelaporan dan Analisis Transaksi Keuangan* (PPATK), which became operational in October 2003.

Seeking to address the FATF's remaining concerns, in September 2003 the Indonesia Parliament passed Law No. 25/2003 amending Law No. 15/2002. The amendment focused on tackling several weaknesses in the original legislation and included an improved definition of money laundering that made it a criminal offense for anyone to deal intentionally with assets known, or reasonably suspected, to constitute proceeds of crime with the purpose of disguising or concealing the origins of the assets. Law No 25/2003 also removed the threshold requirement and expanded the scope to cover assets from terrorist activities. The law also established clear and thorough obligations and reporting requirements organization regarding transactions and the persons making them. Finally, the law provided for mutual legal assistance with respect to money laundering cases and, in March 2006, the Government of Indonesia enacted Mutual Legal

Assistance (MLA) Law No. 1/2006, establishing formal, binding procedures to facilitate MLA with other sovereign states.

Indonesia is a party to numerous relevant treaties, including the United Nations Convention against Illicit Traffic in Narcotics Drugs and Psychotropic Substances Money (Vienna Convention) and has criminalized money laundering on the basis of Vienna Convention requirements (1998). As a member of APG, Indonesia benefits from the organization's regional partnership with the FATF. As a member of the Egmont Group, the FIU welcomes bilateral assistance from various countries, including the United States. International organizations such as the Basel Committee on Banking Supervision, the International Organization of Security Commissions (IOSCO), and the International Association of Insurance Supervisors (IAIS) all have basic, non-binding principles related to preventing and eliminating money laundering that Indonesia is striving to integrate into the overall framework. Indonesia is presently a signatory to The United Nations Convention Against Transnational Organized Crime (Palermo Convention); however, government institutions are still discussing its ratification.

The Central Bank plays an integral role in the anti-money laundering framework; the banking sector represents the largest pool of market participants with reporting obligations of suspicious financial transactions. Consistent with the Basel Committee on Banking Supervision recommendations, they have issued regulations on the principles of Know Your Customer (KYC). The KYC principles were embodied in Regulation No. 3/10/PBI/2001 BI issued in June 2001. The regulations were issued in advance of the passage of national anti-money laundering legislation. The regulations mandate specific levels of prudence in validating the identity of the banking customer and monitoring and reporting transactions that surpass the threshold established, now set at 100 million rupiah (approximately $10,000 dollars). Since most financial transactions are still conducted with the banking sector due to an undeveloped capital market, the application of KYC is important to the effectiveness of the country's success in combating these crimes.

One missing piece in Indonesia's legal framework is a consolidated law on asset forfeiture. Asset forfeiture is important to successfully combat money laundering by taking away the proceeds gained from criminal activities. Although asset forfeiture is scattered across various laws, such as Criminal Procedures Code, Anti-Money Laundering Law, and Anti-Corruption Law, there remains a need to harmonize these provisions in a stand-alone law to improve Indonesia's asset forfeiture regime. USAID's Financial Crimes Prevention Project (FCPP), in coordination with the U.S. Department of Justice, is assisting Indonesia's government in drafting a stand-alone asset forfeiture law. The FCPP is encouraging the inclusion of "non-conviction-based asset forfeiture" in the new law for the purpose of making the process faster and more effective in stopping criminal offenses.

In their current form, Indonesian laws provide only limited authority to block or seize assets. Under Central Bank Regulation 2/19/PBI/2000, police, prosecutors, or judges can order the seizure of assets of individuals or commercial entities that are declared suspects or have been indicted for a crime. While permission of the Bank is not legally required, in practice authorities would find it difficult to identify assets held in a commercial bank supervised by the Central Bank.

Four years of implementation have offered valuable lessons and experiences to inform future policy initiatives and potential amendments to existing laws. The following are among the potential modifications that are part of the dialogue between PPTAK, Parliament, and other interested stakeholders:

- Tightening the definition of Suspicious Transaction Reports (STRs) and Cash Transaction Reports (CTRs) to eliminate differing interpretations
- Extension of types of organizations subject to reporting requirements (e.g., lawyers, public accountants, notaries)
- Formal recognition of the KYC, currently only addressed in the regulations of the various supervisory agencies
- Expansion of the required reports to include international funds transfers
- Additional provisions pertaining to the freezing, seizing, and forfeiting of assets
- Alignment with related legislation and regulations to eliminate inconsistencies and confusion over implementing authority among government agencies.

There are efforts underway to draft and pass a law that would tackle many of these issues, but no timeframe has been set for passage of the legislation.

Implementing Institutions

The front line in Indonesia's effort to combat money laundering and terrorist financing is **PPATK**, the country's version of an FIU. As the central national agency reporting directly to the President, PPATK is empowered to receive, request, analyze, and distribute to cooperating authorities information concerning suspected proceeds of crime in order to counter money laundering and terrorist financing activities. PPATK is officially recognized as an FIU by international FIUs and is a member of the Egmont Group.

Indonesia possesses a nascent anti-money laundering regime. As the leader in the effort to strengthen it, PPATK remains in a development stage and challenged by typical barriers often faced in these environments. Despite having a broad mandate, strong investigatory powers embodied in the legislation, and general support from the national government, PPATK suffers from several challenges. These challenges include funding shortages, lack of depth in trained and experienced staff, and sub-optimal technology that erodes efficiency and fails to keep abreast of the increasingly sophisticated money laundering and terrorist financing schemes. The fact that the Head of PPTAK is not yet authorized to hire permanent staff is a major institutional weakness. Moreover, interagency coordination, which is vital to the success of the regime, has been inconsistent and still suffers from political infighting.

As part of the effort to enhance the overall coordination of the anti-money laundering regime, Indonesia established the NCC in 2002. Presidential Decree No. 1 in 2004 legalized the NCC. This is a Ministerial-level committee formed to ensure coordination and cooperation among the Ministries that are part of the network to combat money laundering. This committee is the "superstructure" in the Indonesian anti-money laundering regime.

The NCC:

- Coordinates the effort to prevent and eradicate money laundering
- Provide recommendations to the President regarding policies to prevent and eradicate money laundering nationally
- Evaluate and implement how Indonesia attempts to prevent and eradicate money laundering
- Report progress to the President on how Indonesia attempts to prevent and eradicate money laundering.

The NCC is also tasked with engaging the private sector in the policy dialogue about strengthening the country's ability to prevent and eradicate money laundering. The NCC is assisted by a **Working Team** that engages a range of Government Ministries and Agencies that commit to building the country's anti-money laundering regime. The Committee organizes a regular meeting—a minimum of once every six months—where all parties are expected to participate in a constructive dialogue around future policy initiatives and implementation challenges.

The **Central Bank** is a bright spot in Indonesia's AML regime. The Bank has clearly defined authority with respect to its role in protecting against money laundering, and its procedures and implementation efforts are widely considered effective. There are 130 commercial banks under its supervision, and compliance with reporting requirements has steadily climbed over the past few years; 111 banks were in compliance at the end of 2006. The Bank is also authorized to monitor the "money changers," who represent another potential venue for laundering.

The Indonesian government and PPATK have begun to examine alternative remittance systems such as charitable and non-profit entities and non-bank financial institutions. Guidelines have been created in an effort to improve compliance with filing suspicious transaction reports and overall monitoring capabilities of these organizations.

A significant obstacle to the declared commitment to fight money laundering is the law enforcement system. The **Indonesian National Police** (POLRI) has the legal authority to investigate both predicate and money laundering crimes. A special division of POLRI, the **Economic Crime Division**, has responsibility for investigation of money laundering crimes and within this division, there is a specialist AML unit. There are approximately a dozen investigators in Jakarta and a network of investigators at regional police stations throughout the country. For the size the country and potential magnitude of the problem, the police are short of funds, experienced and adequately trained staff, and technology, and they lack proper incentives for aggressively pursuing the suspicious transaction report referrals PPATK makes. There is a lack of specific experience with financial crimes and a general shortage of accountants and auditors. Furthermore, the complexity of money laundering investigations along with the general public perception that the police do not operate in a transparent, consistent, or non-discriminatory manner continues to impede the policing efforts.

Similarly, the **Indonesian court system** is widely considered slow, unorganized, corrupt, and largely ineffective in fulfilling its role in the country's efforts to combat financial crimes. The court system handed down only six court judgments related to money laundering in 2006. AML legislation is still subject to multiple interpretations by judges in the system and ambiguity often exists on jurisdictional matters. Despite a solid legal framework and numerous well intentioned and capable individuals within the system, severe shortcomings in the courts hamper the battle against money laundering.

Beyond the courts, there is also a lack of clarity for **public prosecutors.** As with the courts and the police, prosecutors have limited experience managing cases involving financial crimes. Additionally, the absence of a procedural code for prosecution often creates tension among prosecutors and investigators, which leads to poor coordination. A new criminal procedural code is presently being drafted that could improve this coordination. Public prosecutors have also claimed that certain provisions of the AML law are limiting the number of cases being brought before the courts. More specifically, Indonesia does not require that a predicate crime be proven in order to bring money laundering charges. However, when proceeds from a crime are used as evidence involving a predicate crime, this evidence cannot be used again in a case involving money laundering.

Supporting Institutions

Numerous institutions play a secondary role in support of Indonesia's commitment to combat financial crimes through monitoring and enforcement. These include Customs officials, intelligence services, tax authorities, and securities and insurance market regulators. PPATK has attempted to institutionalize this coordination through the execution of a series of MOUs with government agencies, including the Tax and Customs offices. To date, there are mixed results in engaging each of these bodies in the broad effort to protect the system against money laundering and terrorist financing. Non-bank financial sector participants and their respective regulators, notably the capital markets and insurance industry, have actively engaged in the policy formation dialogue and have pursued the adoption of regulations and capacity building within their organizations, which are increasing monitoring effectiveness. On the other hand, commitment and coordination among the custom offices and intelligence services is virtually non-existent.

There is a similar pattern of inconsistent engagement by numerous private sector participants, including industry trade groups, professional associations, the legal profession, and the media. The banking, capital markets, and insurance sector trade groups and professional associations have demonstrated a commitment to participating in the policy dialogue and ensuring that their constituencies are focused on building effective monitoring capabilities. There is little evidence that domestic non-profit organizations, local government watch dogs, or the media, are focused at this stage on the issues of AML or terrorist financing.

Overall, the effectiveness of the AML regime is dependent on many parties. One measure of the increasing effectiveness of the AML regime is the level of reporting to the FIU (PPATK) of STRs and CTRs. The following table demonstrates a positive trend in compliance among organizations subject to the requirements.

Detail of Suspicious Transactions Reports (STRs)			
Year	Total STRs	Average STRs per Month	Total Reporting Parties
2001	14	--	1
2002	124	10	19
2003	280	23	51
2004	838	70	71
2005	2,055	171	133
2006	3,482	290	161
TOTAL	**6,793**		

Broken down by the type of organization, it becomes evident that there remain significant gaps in compliance for specialized financial service providers; only the commercial banking sector exceed a 10-percent compliance level.

Providers of Financial Services Report STRs, 2006			
Types of Providers	Total STRs per Industry (a)	Total Providers of Financial Services (B)	Percentage
Commercial Banks	130	111	85.38
Rural Banks	2,378	2	0.01
Pension Fund and Financial Institutions	393	8	2.03
Insurance Companies	256	11	4.30
Securities Companies	178	13	7.30
Foreign Exchange	814	15	1.84
Investment Manager	107	1	0.93
TOTAL	**4,256**	**161**	

In addition to STRs, based on Article 3 paragraph (1) letter (b) of the AML Law, providers of financial services must submit CTRs to PPATK. The following table reveals that the commercial banking sector leads the compliance effort.

Cash Transaction Reports (CTRs)			
Type of Provider	Total Reporting Parties	Total CTRs	
		Period Ending Dec ’05	Period Ending Dec ’06
Banks	136	1,536,915	1,967,297
Non Banks			
Securities Companies	--	--	--
Investment Manager	--	--	--
Insurance	4	28	36
Pension Fund	--	--	--
Foreign Exchange	36	662	847
Financial Institutions	--	--	--
TOTAL	**176**	**1,537,605**	**1,968,180**

Social Dynamics

In general, financial crimes lack a public constituency to provide the political energy or pressure to determine the course and scope of future reforms. Money laundering is not on the front of the agenda for most politicians, although there are advocates within the government and implementing agencies dedicated to continuing the efforts to construct a viable AML and terrorist financing regime. There is a notion that proceeds from laundered money, if being invested inside the country, are acceptable if help create employment and income opportunities for low income members of the population; this notion inhibits aggressive enforcement of applicable laws. One respondent noted that, “with limited resources, the only real concern about money laundering is when the money is not being spent inside Indonesia.”

There is limited media focus on financial crimes and there exists minimal expertise on the associated domestic and international issues. A more public campaign about corruption was visible through public billboards and local newspapers.

Indonesia is not presently a haven for money laundering, but remains vulnerable to this possibility based on the weaknesses that exist in this early stage of its effort to build an effective AML regime. Although the pace of reform has slowed since the aggressive effort to remove itself from the NCCT list, Indonesia is still progressing toward an internationally recognized

regime by addressing legislative weaknesses and nurturing the capacity of the key organizations involved in implementation.

Recommendations

Although Indonesia has a nascent AML and terrorist financing regime, there has been a concerted effort in the past few years to accelerate efforts to build an effective system. The parliament has passed critical legislation, although such legislation is not entirely consistent with international standards and still in need of amendments. Key agencies have been created and are slowly building upon limited capacity. Several suggested areas of focus are:

- Draft and pass critical amendments to existing legislation that bolster the regime, including an asset forfeiture law and its implementing regulations, and a criminal procedure code for improving coordination between law enforcement and the court system.
- Provide supervising and investigating entities with sufficiently sophisticated equipment, such as state-of-the art computers, to meet the demands of the technical nature of investigating financial crimes and improving interagency communications.
- Tailor a regularly occurring training course to law enforcement officials, particularly police, on best practices for financial crimes-related investigation procedures as well as specific case-building techniques (e.g., evidence gathering, interviewing, research).
- Provide students with a specialized financial crimes curriculum to ensure that knowledgeable human resources are available in the field.
- Attract more professionals from specialized professions, such as accountants and auditors, into the field.
- Improve interagency coordination to strengthen the implementation of existing legislation, limit stalling of progress toward constructing a sound AML regime, and reduce political infighting.
- Training for professionals engaged in financial crimes investigation and prosecution (e.g., FIU, police, courts) remains valuable, though there should be a focus on building this capacity within Indonesia.

INTELLECTUAL PROPERTY

Introduction

IPR is an umbrella term for various legal entitlements the government awards to individuals or organizations principally over creative works: inventions, literary and artistic works, symbols, names, images, and designs used in commerce. The holders of these legal entitlements may exercise various exclusive rights in relation to the subject matter of IP, including, among others, the right to control, produce, copy, distribute, and license property in question within a country. IP laws and enforcement vary from jurisdiction to jurisdiction. However, there are numerous international instruments to harmonize these laws, the most commonly known of which is the 1994 WTO Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPs).[97] IP consists of a few main categories, some better known or understood than others: patent, trademark, copyright, industrial design, geographical indicators, and trade secrets. Other, more specific categories, such as protection of plant varieties and integrated circuits, exist as well, often as a subset of the other categories mentioned.

In the modern global economy, the creation of knowledge and its adaptation to product designs and production techniques are increasingly essential for commercial competitiveness and economic growth. Research indicates that higher levels of IP protection have a positive effect on bilateral manufacturing imports into both small and large developing economies. In addition, they help to stimulate technology transfer through investment in production and research facilities, as well as through cross-border technology licensing.[98] Moreover, is has been shown that foreign and international firms are most likely to choose foreign production over export if the attributes of a particular location favor production abroad, including strong IP protections (as well as, for example, lower wages or proximity to international markets). For many developed countries, IP-intensive goods and services constitute a rising share of the income they derive from their presence in foreign and developing markets. In addition, IP protections can lead to improved public safety and health as counterfeit (and therefore unregulated) goods have a difficult time entering the flow of commerce. In sum, stronger IPRs can have a significantly positive effect on total trade.

International policies toward protecting IPRs have seen profound changes over the past two decades. Rules on how to protect patents, copyrights, trademarks, and other forms of IP have become a standard component of international trade agreements, and are being adopted more broadly on a domestic basis. Indonesia has been part of this trend. Since the late 1990s, Indonesia has adopted numerous international and local IP standards to strengthen its domestic legal framework. However, implementation lags behind, and Indonesia ranks poorly in numerous categories related to IPR, including having one of the world's highest rate of pirated goods in categories such as optical discs, books, and software.[99] This situation has, according to reports,

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[97] See http://www.wipo.int/portal/index.html.en for a full exposition of the various international instruments involved with intellectual property.

[98] http://www.worldbank.org/research/IntellProp_temp.pdf

[99] Piracy in Indonesia is approximately 85-90 percent in 2006, eight worst in the world. US Special 301 report 2007

been a cause for lowered FDI in the country.[100] Beyond the establishment of the legal framework, and despite a number of well-intentioned efforts, public and private institutions have not succeeded in significantly improving IP protections or knowledge. Entrenched cultural attitudes that limit the population's interest or capacity in appreciating the importance of IP protections exacerbate these problems.

Legal Framework

Subsequent to joining the WTO in 1994, Indonesia made great efforts to bring its legal framework in line with the requirements of that and other related bodies. It has become a contracting party to a number of international instruments. It has passed new laws on copyright, trademarks (including geographical indicators), patent, integrated circuits, industrial design, trade secrets, and protection of plant varieties, and repealed many laws that were not in conformity with international standards. In addition, it has entered into force a number of regulations and presidential decrees, ministerial decrees, and other regulations needed to fully implement those laws. While the basic legal framework is for the most part internationally compliant, a few nuances remain to be adjusted and some implementing regulations are lacking. It should be noted that Indonesia, like much of the world but unlike the United States, uses a "first to file" system for patents.[101]

With respect to international instruments, Indonesia has in force:

- The Paris Convention of 1967, relating to the protection of industrial property
- The Hague Agreement, concerning the International Registration of Industrial Designs
- The Berne Convention of 1971, relating to the protection of literary and artistic works
- The Trademark Law Treaty
- The Madrid System for the International Registration of Marks
- The Singapore Treaty on Trademarks
- The Patent Law Treaty
- The Patent Cooperation Treaty
- The World Intellectual Property Organization (WIPO) Copyright Treaty
- The WIPO Performances and Phonograms Treaty.

While other international instruments could be ratified, this list includes the major international instruments needed for an IP protection regime. A presidential decree comprising representatives from the public and private sectors created a drafting committee that completed laws related to

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[100] Apriadi Gunawan, "Indonesia 'still poor' at protecting intellectual property rights," *The Jakarta Post*, May 24, 2007.

[101] The United States uses a *first-to-invent* system, unlike most other countries in the world. Invention in the U.S. is generally defined to comprise two steps: (1) conception of the invention and (2) reduction to practice of the invention. When an inventor conceives of an invention and *diligently* reduces the invention to practice (by filing a patent application, by practicing the invention, etc), the inventor's date of invention will be the date of conception.

these treaties and other areas of IP; these laws are seen as being adequate for Indonesia's current needs. These laws include protection for all the major categories of IP, are non-discriminatory toward foreigners seeking to apply for such protections, allow for the relevant administrative body to promulgate the necessary regulations to implement the law, and outline both civil and criminal penalties for violations.

In addition, other regulations have been passed to improve the status of IP in Indonesia, such as the Presidential Decree of 2006 creating the National Team for the Prevention of IPR Infringement. This relatively new, high-level, intra-government body brings together 17 different ministries to discuss and set IPR priorities for Indonesia. According the decree, the Task Force's aims are to:

- Formulate a national policy to prevent IPR infractions
- Determine national efforts needed to prevent IPR violations
- Assess and determine measures for resolving strategic problems concerning IPR infractions, including prevention and law enforcement activities in accordance with the main duties of participating agencies
- Educate and socialize related government institutions and society about IPR matters through various activities
- Improve bilateral, regional, and multilateral cooperation to prevent IPR violations.

Other government regulations include the 2005 regulation regarding consultants (practitioners) in the IP field. This regulation outlines the role of IP consultants and requirements to support those filing for IP protections.

Terms of Protection	
Copyright	During the life of the author plus 50 years
Trademark	10 years and may be renewed for periods of ten (10) years each
Patent	20 years from filing date of the application
Simple Patent	10 years from the filing date of the application
Utility Model	7 years from filing date of the application without renewal
Industrial Design	10 years from filing date of the application
Lay-out design of Integrated Circuit	10 years from filing date of the application
New Plant Variety	25 years from the date of grant for perennials, and 20 years for annuals.[102]
Trade Secrets	No time limit so long as the information in question maintains beneficial economic value.

Despite the relatively diverse field of implementing regulations, respondents cited a number still needed, including, most significantly, regulations on licensing agreements. Although a licensing agreement is not required to be registered, they are more difficult to prove and can lead to the agreement not being binding against third parties.

In addition, respondents noted a need for implementing regulations in two other areas, which would provide valuable assignments under the Indonesia Anticorruption and Commercial Court Enhancement Project (In-ACCE): regulations and/or administrative procedures defining "well-known" trademarks to assist the Trademark Office in examining applications and assist owners of well-known marks in canceling pre-existing registrations; and (2) regulations and/or administrative guidelines on examining and issuing injunctive relief.

Other more specific laws and regulations for the situation in Indonesia have also been passed. Unique to Indonesia is a kind of patent called the "simple patent." Although similar to the utility model patent used in Europe, no other country has exactly the same concept. Its main objective is to provide protection for simple business processes – e.g., an inventive step in a production process – and non-sophisticated technologies, in particular for small and medium-size businesses. By law, the application process and requirements of patentability are easier to satisfy than standard patents, and the protections last for only 10 years. Unfortunately, this patent is not widely used because there is, among other reasons cited by respondents, some confusion between it and industrial design patents. Another law recently passed to meet specific circumstances in Indonesia is with respect to combating piracy. The law makes shopping mall owners liable for the piracy of shopkeepers in their mall. If a store is found to sell counterfeited or pirated goods, the mall owner can be sanctioned as well.

Implementing Institutions

The successful implementation of an IPR regime depends on the operation of three separate but interacting government sectors: the IPR registration office, in Indonesia the Directorate General for IPR; the Indonesian National Police and related enforcement bodies; and the courts. In each case, while progress has been made, more remains to be done to achieve a more successful IPR regime in Indonesia.

The **Directorate General for IPR** is a part of the **Ministry of Justice and Human Rights** in Indonesia. It is the body responsible for the registration process for all forms of IP. It is divided into six sub-units, also known as directorates: Patents; Trademarks; Copyright, Industrial Designs, Layout Design of Integrated Circuits, and Trade Secrets; Information Technology; Co-operation and Development; and the Secretariat of the Director General. The first three are involved with the registration process and the last three with the operations, development, and administration of the Directorate and IP in Indonesia in general. In all cases, each directorate completes a regular review of its procedures and the state of the law to ensure that they provide adequate customer service and that Indonesia is in compliance with developing international standards.

The **Directorate of Patents** consists of 75 examiners and is divided into three divisions: chemical, engineering, and biotechnology; electrical and physical; and mechanical. While examinations take place in Jakarta, there are 33 satellite offices throughout the country that provide support and receive applications through the local offices of the Ministry of Justice. Both

domestic and foreign applicants can file applications, although foreign applicants are required to have a local proxy. Foreign applications make up the vast majority (93 percent) of patent applications, although the number of local applicants is slowly climbing)

The Directorate of Patents seeks to review a patent application and complete the patent examination within three years. According to multiple respondents, however, a backlog of applications continues to grow. Processing a patent application is a relatively cooperative process: the patent examiner and the applicant work to ensure that, *ab initio,* the application meets all administrative requirements so as to not be refused on non-substantive grounds. Applications for patents in Indonesia that have already been patented in other countries are given a separate priority. By using the reports provided from the other country, the patent can be processed more expeditiously.

The **Directorate of Copyright, Industrial Design, Layout Design of Integrated Circuits, and Trade Secrets** has, at the time of this report, 12 examiners for industrial design applications and five for patent applications. As with patents, this directorate demands a great deal of depth of knowledge given the broad subject matter. Generally, an application to this directorate will be refused only if a valid objection arises after a notice of the application has been published. However, more than one respondent stated that the coverage of such publication is inadequate and as a result many approved applications are not new or novel ideas. This leads to conflicting claims to the same IP.

The **Directorate of Trademarks** has recently been cited for improving its services, apparently due to new, experienced leadership. This purview of this directorate includes collective marks, source of origin, and geographic indications. The latter, however, is not well understood and is rarely used.

Within each of the Directorates, respondents cited a number of similar issues as hindering their ability to quickly and efficiently process an application. Foremost among them was problems with respect to human resources. Examiners are most often recent university graduates with little practical experience or specialization. While they do receive training both internally and from international bodies such as the WIPO, the European Union, and the U.S. Patent and Trademark Office, respondents stated that the quality of the examiners was uneven. Making the job more difficult, salaries for examiners are too low to attract and keep qualified examiners. In addition, under the current structure, the DG IPR has little control over its own recruitment process. If it needs a new examiner, it sends a request to the Ministry of Justice, who then interviews and hires the individual and sends that person to the DG IPR.

Another commonly cited issue was the lack of information technology solutions within the DG IPR. Only recently did the DG IPR create an internet-accessible database search for registered IP. The long-term efficacy of this database was not certain as of the writing of this report, although initial impressions were positive. Another shortcoming has been the inability to file applications electronically. This problem may be rectified in the near future as the DG IPR is testing a program to allow such filing. Last, because of the lack of IT capacity, recordkeeping with respect to the payment of fees to the DG IPR has been inconsistent, leading to multiple and lost payments.

A recent positive development within the DG IPR was a change in the control over user fees. Previously, all fees paid to the DG IPR went to the Ministry of Justice. However, in 2004 the regulation was changed so that 25 percent of such fees went directly to the DG IPR. According to reports, this change has led to improved and broader services. Among the improvements, the DG IPR has been able to provide more education and training, both internally and to the broader population. As another example, in early 2007 the DG issued a letter to all office building owners encouraging them to ensure that their tenants were in compliance with the IP laws, in particular the use and licensing of software.

With respect to all IP applications, if it the DG IPR rejects an application, an applicant has the right to an administrative appeal within the Directorate. This process is relatively simple and straightforward. If this is not resolved to the satisfaction of the parties, they can take a further appeal to the commercial courts.

The **Indonesian National Police** also provide a vital part of IP protection. Without police enforcement, there is little disincentive to observe IP law and violations of IP become widespread. Historically the Indonesian authorities have made little effort to provide such enforcement, and as a result levels of piracy of optical discs, books, and software in Indonesia are among the highest in the world. According to various respondents, copyright infringers have had success paying informal fees to the police to gain protection from enforcement of IP law. However, recently the police have completed a series of highly publicized raids on counterfeit optical disc production plants.

Trademark, patent, and design infringements are all "complaint-based" crimes where the rights owner must file a formal complaint with the police before any action can be taken. Copyright infringement is a "non-complaint based" crime, which means that the police may take action with or without a formal complaint from the rights holder. Except with high-profile types of infringement such as optical disc piracy, the police will not act without a complaint, because of, respondents report, a lack of funding for such activity. In any case, once the police become aware of an infringement they are required to investigate. Normally, this will mean a raid to seize evidence and develop the case. In practice, the police pass few cases to the Attorney General's office for prosecution.

In addition to the police, various **government departments**, including the DG IPR have Civil Service Investigation Officers (PPNS) who are authorized under investigate instances of counterfeiting. However, while these officers may enter premises and seize goods, they may not arrest or detain suspects and must report their findings to the police. As a result, most infringers are not concerned with PPNS unless they are acting in concert with the police.

Various **international groups** have provided training and education to the police. Nonetheless, police are not seen as effective with respect to IP, as they do not consistently conclude investigations or interpret the law. Funding for the police contributes to these shortcomings. At present there are only funded to 30 percent of their capacity, and have the equivalent of US$250 dollars per investigation of a possible IP infraction – clearly not enough to address the situation adequately. In addition, salaries within the police department were cited as being low, making them more susceptible to bribes.

The **Customs service**, with respect to both exports and imports, are also involved in attempting to control the movement of counterfeit goods. Interviewees described their efforts as being primarily *ad hoc*, partly because there is no clear implementing regulation to guide their efforts. In most cases, Customs officers would not act unless the IP rights holder could show a reasonable suspicion of counterfeit goods being transported. In general, Customs was not seen as assisting with IP enforcement to the greatest degree possible, particularly with respect to pirated exports.

With respect to the **legal system**, other chapters in this report discuss the situation in the courts in greater detail. Therefore this section will only focus on those aspects related to IP. With respect to civil enforcement, such as appeals of initial conclusions regarding an IP application before the DG IPR and other IP-related actions such as cancellation of IP rights, cases are usually brought before the Commercial Courts. Judges' expertise with respect to IP is generally seen as inconsistent. Nonetheless, most cases are concluded within statutory periods of six months for patents and three months for other forms of IP.

An important part of IP protection is a party's ability to seek an injunction against alleged violators while a case is being heard. This tool has not been employed in Indonesia, as implementing regulations have not been issued in this regard. In this vein, commercial judges would like In-ACCE to assist in developing the implementing regulations so they can fulfill their mandate. In many cases, it should be noted that the parties settle out of court and outside any of the alternative dispute resolution mechanisms.

For criminal matters, there have been very few successfully prosecuted cases. As mentioned previously, police lack resources to adequately investigate cases. Therefore, prosecutors often lack sufficient evidence to pursue cases. In other cases, respondents stated that prosecutors and judges can be subject to bribes to end an investigation or influence outcomes in court. As a result, few cases are successfully prosecuted and meaningful convictions of IP violations have been non-existent.

For all cases that reach a decision, obtaining a printed copy of the decision (a basic service that a court should provide) is difficult, although courts have been more successful in publishing new court rules and laws.

Supporting Institutions

While historically institutions that support IP enforcement in Indonesia were highly active over time their role has diminished, although a few individuals and groups remain active. According to respondents, this has occurred for two primary reasons: the initial work to bring Indonesia up to international norms has been completed and therefore there is less need for reform, and because there is a lack of funding to support such groups.

With the respect to the practice of IP, while **lawyers** play an important role, the field is augmented through **IP consultants**. These individuals are not necessarily lawyers, but they provide legal assistance with respect to filing IP applications, legal claims, etc. To be an IP consultant, one must be trained and pass an exam the government offers. According to respondents, the majority of organizations seeking legal support of IP consultants and lawyers are multinational corporations seeking trademark assistance. In an effort to encourage local

applicants to use the IP system, some IP firms offer *pro bono* assistance to local applicants. With respect to the bar association, while it has provided some training and expertise to lawyers and others, there is no regularized committee or process with respect to IP issues. At present, the practice of IP law by both lawyers and IP consultants is considered a niche practice but sufficient to meet the current need.

There are a number of **trade associations** that deal with IP issues, but they were not reported to be particularly effective or active. Historically, the Indonesian Intellectual Property Society was a part of the initial push in the late 1990s to bring the country's legal framework in line with international norms. In addition, it provided training regarding IP issues. However, recently it became relatively inactive due to a reported lack of funding, among other reasons. Other organizations that deal with broader IP issues, such as the recently created trademark association, were reported to also be inactive. Other specific areas of industry, such as the recording and publishing industries, have their own trade associations to provide advocacy with respect to IP issues. As a result of the relatively inactive domestic civil society, multinational corporations with interests in Indonesia have taken it upon themselves to support their interests. More specifically, they have formed their own organizations to deal with IP issues such as counterfeiting and piracy. Other international organizations, such as the Business Software Alliance, have provided training and information related to IP. In addition, larger multinational corporations such as Microsoft have acted independently to provide a broad array of assistance, from education to providing hardware and software.

Perhaps the most well-known supporting institution is the **National Team for IPR Infringement.** This high-level body garnered a great deal of interest when first created by Presidential Decree in early 2006. To date its impact has been minimal. Many respondents stated that they felt that this body is not funded sufficiently to achieve its mandate and feared that, despite good intentions, it would become a figurehead organization. Given the composition of the group, however, it is well positioned to achieve greater intra-government co-operation with respect to IP issues.

Additionally, the government has supported IP issues through other means. For example, recently on "World Intellectual Property Day" the government hosted 14 different activities, including seminars and exhibitions, across the country, and the President gave awards to those who have been working to support IP protection. In addition, the Ministry of Research and Technology has a program to attract and fund research to explore new inventions and domestic patents.

Internationally, Indonesia participates in and receives assistance from various organizations. Within ASEAN there is a working group on IP cooperation and another on copyright issues, both of which work to harmonize member nations' laws, to share best practices, and to assist each other with the implementation of new international standards. Such cooperation is done through both public and private sector participation, and many Indonesian individuals and groups have been involved. Several bilateral efforts exist as well, through, for example, the Australian Agency for International Development (AusAid), the Japanese International Cooperation Agency (JICA), and the US Department of Justice (through the International Criminal Investigative Training Assistance Program (ICITAP)). Assistance in this regard ranges from basic education for small and medium-size business owners to directly assisting police with IP investigations.

With respect to **academia**, the support for IP issues is thin but developing. Presently, only larger universities provide courses on these issues and still fewer have centers of learning based around IP. The University of Indonesia Intellectual Property Center is perhaps the most widely known. Created in 2000, its role is to contribute to the development of Indonesia's IP legal system through legal education, academic research, and IP legal services. In 2005, in cooperation with WIPO and the WIPO University Initiative, the University of Indonesia became the University Intellectual Property Coordinator (UIPC). The UIPC provides information and training on IP-related matters, serves as a public research center for IP matters that may arise at different levels within a university, and supports research and development related to IP. Despite the positive developments, respondents cited the overall lack of depth of IP education and other academic opportunities as a shortcoming to developing the field in Indonesia.

Social Dynamics

Overall, Indonesia has made great progress in the last decade with respect to IP protections. A great deal of this progress can be attributed to Indonesia becoming part of the international system through the WTO, through which it was required to change its laws to meet treaty obligations. But after this initial push, Indonesia has not done enough to educate the populace about IP protections and fully develop the IP system. Recently the government has shown a renewed interest in improving Indonesia's standing through the creation of the high-level National Team for the Prevention of IPR Infringement, and executing raids again counterfeit goods producers. Nevertheless, there is a lack of understanding among much of the population about the importance of IP and IP protections, a problem bolstered by the poor enforcement of IP rights.

Statistically, levels piracy and counterfeit goods in Indonesia are significant; the country currently ranks eighth in the world with respect to levels of piracy. Numerous sources stated that this has had a chilling effect on foreign investment in the country. The largest problem exists with optical discs, where counterfeiting operations exist in the open as there is little fear of repercussions. Recent police raids against such operations may help to temper these attitudes, but until prosecutions and convictions occur consistently and regularly (and the convictions are for the manufacturers and distributors of such goods and not merely the retailers, as has been the case thus far for the few convictions that have occurred), it appears unlikely that much will change in the near term.

Estimated levels of, and trade losses due to, copyright piracy (in millions of US$)[103]

Industry	2002		2003		2004		2005		2006	
	Loss	*Level*	*Loss*	*Level*	*Loss*	*Level*	*Loss*	*Level*	*Loss*	*Level*
Business Software	109.6	89%	94	88%	100	87%	153	87%	156	85%
Books	30	N/A	30	N/A	32	N/A	32	N/A	32	N/A
Records & Music	92.3	89%	44.5	87%	27.6	80%	13.8	88%	17.2	91%

Many reasons exist for these high levels of piracy. Some are due to prurient criminal interests. Other factors, however, including societal characteristics and attitudes toward IP issues and current economic conditions, contribute to high levels of piracy but also more generally make the establishment of a rigorous IP regime difficult.

Traditionally, Indonesian society does not share the same attitude as western society toward individual property. Broadly speaking, Indonesian society embodies the concept of "*Berbagi,"* or sharing or togetherness. Property and novel ideas are expected to be shared for the benefit of the community and there is less emphasis on private possession of property. The basic precepts of IP protections are not highly valued, as the property of one are thought of as being for all, and others enjoying that property it is not considered a violation of an individual's rights. While this attitude is reportedly changing in the more urban areas, it is still common outside the main cities. As a result, piracy and counterfeiting are not viewed as actual crimes and are in many ways considered acceptable.

This communal conceptualization also has broader relations to IP issues. In Indonesia and other developing nations, a growing area of interest is with respect to IP protections for a collection of community properties known as "genetic resources, traditional knowledge, and folklore." These items are generally communally developed properties in forms such as specific herbs and plants that grow in a particular area, local foods, dance, music, textile patterns, and other traditional cultural expressions. While there are some protections in this regard, the current coverage of IP law is not adequate. In many cases foreigners are able to gain an understanding of the property in question and exploit it to their advantage with no benefit to the originally creating community. Currently an international cooperative effort is underway to create a new means of protection; Indonesia is playing an important role in this effort because many of its communities have property that could be protected. At present only a very early draft law exists.

A second problem preventing the successful implementation of IP protections is Indonesia's economic situation. Approximately 20 percent of the population lives in poverty. As a result, individuals are more likely to buy counterfeit goods that are more affordable than the authentic products.

A final factor that complicates full IP protections is the large number of "bad faith" applications received at the DG IPR. The "first to file" system in some ways encourages such activity as applicants known as trademark speculators or squatters can take ideas from other countries and file them regardless of whether they were involved in the creation of the subject matter of the application. For example, one company reportedly filed applications for over 3,000 trademarks. As a result, the DG IPR and courts spend a great deal of time filtering out these bad faith applications.

Recommendations

- With respect to current legislation and regulation, missing regulations such as dealing with license agreements, Customs' role with respect to IP, and injunctive relief related to possible IP violations should be promulgated.
- As the law has been expanded to include liability for owners of shopping malls who allow their tenants to sell pirated and counterfeit goods, the possibility of creating

criminal liability for those who knowingly purchase counterfeit goods should also be explored.

- Data is needed with respect to levels of counterfeit exports to help the police and Customs better target enforcement efforts.
- The DG IPR registration process should be improved by employing information technology solutions. This will make the registration process more efficient, consistent, and transparent.
- The DG IPR should be made an independent agency, giving it full control over its budget and hiring and firing practices. In addition, all fees paid to the DG IPR should remain in its control.
- With respect to the police, salaries should be raised so that police officers are less susceptible to bribes. In addition, the police should be better funded to allow for more and deeper investigations into possible IP protections violations.
- Training should be expanded for judges, court staff, attorneys, and IP consultants with respect to IP issues.
- Renewed efforts should be undertaken to modify societal attitudes through education about the importance of IP protections. A public-private partnership should be developed to assist in the development of a public education strategy. This could have the additional beneficial effect of reinvigorating domestic civil society's interest in IP.
- Support should be given to academic institutions so that they can expand their IP education efforts.
- Rights holders should be encouraged to be more involved in the process. This includes being more knowledgeable of their rights, being more active in investigation of cases, and supporting and participating in civil society organizations.
- While recent police raids against counterfeiting operations is an excellent start, these will be merely symbolic gestures if those arrested are not prosecuted, a step that has been lacking in prior such circumstances. Generally speaking, efforts must be made to ensure stronger prosecutions.

ATTACHMENT I: COMPILATION OF RECOMMENDATIONS

Company Law and Corporate Governance

No.	Type	Recommendation	Priority	Duration
1	Company Law	Establish a process for continuous review, revision, and updating of the new company law. This can be done through the new Company Law Monitoring Experts body and other relevant organizations.	High	Medium-Term
2	Company Law	Continue to broaden the new Company Law consultation process. Solicit input from select prospective users, including lawyers, businesspeople (including entrepreneurs, company directors, and commissioners), other professionals (including accounting firms, judges, notaries, corporate governance organizations, BAPEPAM, and the stock exchanges), and relevant ministries.	Medium	Medium-Term
3	Procedural Reform	Make registration quicker—it should take at most a few days.	Medium	Short-Term
4	Procedural Reform	Reduce the cost of registration, and publicly post fees.	Medium	Short-Term
5	Procedural Reform	Reduce subjectivity in the registration process—there should be no government discretion in the process. The government should only check for ministerial errors in the filings.	Medium	Medium-Term
6	Procedural Reform	Provide standard printed forms that a small business can use without a lawyer or notary.	Medium	Medium-Term
7	Procedural Reform	Minimize or eliminate notarial requirements.	Medium	Medium-Term
8	Procedural Reform	Eliminate the *Gazette* publication requirement.	Medium	Medium-Term
9	Procedural Reform	Make it easy to register (create) a new company with limited liability without regard to whether the company needs licenses and permits for later specific activities.	Medium	Medium-Term
10	Procedural Reform	Maintain basic information about companies and make it available to the public for free.	Medium	Long-Term
11	Procedural Reform	Establish and maintain an attractive website that clearly displays governing laws, procedures, fees, forms, and company data.	Medium	Long-Term
12	Procedural Reform	Coordinate and streamline the process for obtaining business and sectoral licenses and permits, especially for startup businesses.	Medium	Medium-Term

13	Institutional Reform	Establish the Investment Coordinating Board as a true "one-stop shop" regulator with real power to coordinate and make substantive decisions.	High	Medium-Term/ Long-Term
14	Further Analysis	Expand the work already initiated by the Asia Foundation.	Medium	Long-Term
15	Corporate Governance	Take more steps to strengthen monitoring and enforcing good corporate governance.	Medium	Medium-Term
16	Corporate Governance	Update and establish a procedure for continually revising the BAPEPAM rules so that they are consistent with the Code of Good Corporate Governance and other best practices. Consider requiring all public companies to publicly explain any noncompliance with the new Code of Good Corporate Governance.	Medium	Medium-Term
17	Regulatory Reform	Clarify and specify the enforcement powers of BAPEPAM and the stock exchanges, including the power to levy fines, issue cease and desist orders, suspend trading in a particular stock, de-list a particular company, bring litigation in court, and publicly expose defaulting companies through public announcements or press releases. This clarification could be accomplished through additional BAPEPAM rules or an amendment of the Capital Market Law.	High	Short-Term
18	Corporate Governance	Increase attention to corporate governance in: (1) closely-held, small, and family companies, which, though they are the bulk of Indonesian companies, are not subject to BAPEPAM or stock exchange regulation; and (2) state-owned companies, which are not governed by the Company Law. Regarding closely-held companies, the Company Law could be revised and strengthened as suggested in the annex that follows this recommendations section. Also consider expanding the Code of Good Corporate Governance to include specific provisions for private and family companies. Regarding state companies, the code could be revised to incorporate or adapt provisions of the OECD Principles of Corporate Governance for State Owned Enterprises.	High	Medium-Term/ Long-Term
19	Procedural Reform	Analyze the actual rates and specific drivers of informality. Study especially the phenomenon of larger businesses that choose to remain informal. Base reforms on a more nuanced understanding of the drivers of informality.	Medium	Medium-Term/ Long-Term
20	New Company Law (General)	Overall drafting and organization. To make the law more useful and user-friendly, begin with a table of contents listing all articles; give each article a subject heading stating its contents; and place each subject in the same place when possible (e.g., the shareholder vs. director or commissioner lawsuit standards now in Articles 61, 95 and 111-12).	High	Medium-Term

21	New Company Law (General)	Allow one-owner companies.	Medium	Short-Term
22	New Company Law (General)	Eliminate the concept of legal capital from the law, together with associated concepts such as "nominal value of a share." Many other countries have done this in recognition that those concepts are unclear, complex, and confusing (and subject to manipulation) as an accounting matter, and do not serve to protect either creditors or shareholders as a practical matter; they are also not enforceable. The initial capital requirement also stands as a barrier to registration of small entrepreneurial companies.	High	Short-Term/ Medium-Term
23	New Company Law (General)	Regarding company registration, embody the second "Recommendation" above in the law itself. This would require revising Articles 7-18. Also state clearly that a company can begin its existence (and with limited liability) before it obtains all necessary sectoral permits or pays later-assessed fees. This is important for getting a company started and organized pending the long delays in receiving those permits.	Medium	Short-Term
24	New Company Law (General)	To improve financial reporting and transparency, require that all companies of the types stated in Article 68 must have annual independently-audited financial statements prepared in accordance with international accounting standards.	Medium	Short-Term
25	New Company Law (General)	Clarify and simplify the rules for amendment of the Articles of Association (Articles 19-28). For example: do not require Minister approval or a notarial deed for amendments that the shareholders have properly approved (21); and provide that such an approved amendment is effective at the moment of its filing in the public registry.	Medium	Short-Term
26	New Company Law (General)	State in more detail the rules for stock. For example, state that every company must have common stock and that all common stock has the same rights, which include one vote per share; this promotes transparency and investor control (and would require a change to Article 82). State that any company may also have one or more classes of preferred stock with preference over common stock for dividends and/or liquidation distributions, but all of the rights and preferences of each class of preferred stock must be fully stated in the company's publicly-filed Articles of Association. Further, state that preferred stock does not have voting rights (except possibly in exceptional cases where preferential dividends are in default or the preferred is convertible into common stock).	Medium	Short-Term

	New Company Law (General)	State explicitly that bearer shares are prohibited. As a further point, the limitations on share transfer in Articles 57-60 should not be permitted in public companies. Expand the dissent and "putback" provisions in Article 62 to add detailed procedural and appraisal rules as in other countries' laws. Make it clear in the new law that a company may issue securities other than shares, including bonds, convertible instruments, options or warrants to acquire shares, and Islamic securities.	Medium	Short-Term
27	New Company Law (General)	Add detail to the rules for convening, conducting, and voting at shareholder meetings. Include more rules for advance notice to shareholders, setting the record date, setting the agenda (including allowing shareholders to propose agenda items including director nominations), proxies, more detailed quorum requirements, rights to secret ballots in director elections and other cases, vote counting safeguards, minority calling of shareholder meetings and other matters. International experience has shown that these seemingly minor details can be essential to protect the integrity of shareholder control and to forestall argument and dispute.	Medium	Short-Term/ Medium-Term
	New Company Law (General)	State that ordinary matters are to be decided by majority vote of shareholders (not 50 percent as now in Article 85 (at least in the English translation)), and clarify and add to the current list of major decisions the items that may require a two-thirds vote. Consider adding a "more than 50 percent" asset sale to the items that require a supermajority vote under Article 87 (since that is now included in the items in Articles 62 and 100) and consider reducing the three-quarters vote requirement in Article 87 to two-thirds; international experience has shown that it is often impossible for companies to muster a vote as high as three-quarters on any issue.	Medium	Short-Term

28	New Company Law (General)	Clarify the roles and responsibilities of a company's boards of directors and commissioners. For example, provide that all directors and commissioners are to be elected or re-elected at each annual shareholder meeting (although there should be no limit on how many times one can be reelected); that their individual compensation and benefits must be approved by the shareholders See Articles 94 and 110); that cumulative voting may be adopted so that minority investors can elect directors in proportion to their minority holding; that a public company must have some independent directors. The board of a public company must have an audit committee that includes or consists exclusively of independent directors, a nominating committee, and a compensation committee with duties spelled out in the law. Consider more detailed rules for convening, conducting, and voting at directors' and commissioners' meetings and allowing "virtual" electronic meetings and actions by consent with no meeting at all.	Medium	Short-Term
29	New Company Law (General)	Add new rules to give a company more freedom and flexibility in declaring dividends and buying back its own stock, and add more realistic restrictions to protect creditors. Such restrictions should include a prohibition on dividends or buybacks that would render a company insolvent on a balance sheet test or unable to service its debt in the ordinary course of business. The formalistic restrictions now in Articles 70-72 (based on reserves, "profit balance," and paid-up capital) do not reflect actual business practicalities or protections as seen by creditors. Both dividends and buybacks should be subject to the same restrictions. Also, expand Article 72 to state that the directors who cause a company to pay prohibited dividends, and shareholders who accept them knowing they are prohibited, are personally liable to return the amounts illegally paid or received.	Medium	Short-Term/ Medium-Term

30	New Company Law (Fiduciary Duties)	The BAPEPAM rules and the Code of Good Corporate Governance cover this subject, but it should also be covered definitively in the company law because the company law – unlike the rules and the Code – is both (1) mandatory and (2) applicable to all companies, public or private. It is suggested that the provisions in the draft company law (see Articles 61, 95 and 111-12) be consolidated and expanded to incorporate internationally-recognized definitions of the duties of care, good faith, and loyalty that directors, commissioners, and company officers should have to the company, and to extend some duties to controlling shareholders of the company. These (including rules for approval of conflict transactions) should be consistent with the rules now in the Capital Market Law, the BAPEPAM rules, and the Code of Good Corporate Governance. The law should also set more detailed rules for lawsuits against directors, commissioners, and other persons in control of a company, even if such lawsuits are yet unknown in Indonesia.	High	Medium-Term/ Long-Term
31	New Company Law (Private and Smaller)	The majority of Indonesian companies are in this category, and the law should have simpler and more flexible provisions for them, as opposed to public companies that can have an unlimited number of shareholders, including passive investors who need more formal protections as are required in a PT. The company law should be easily usable by the smallest businesses with no need for a lawyer, or by large closely-held businesses, including international joint ventures whose owners can custom-negotiate a shareholder agreement among themselves.	High	Long-Term
32	New Company Law (Private and Smaller)	Make clear that a private company's members, unlike in a PT, may structure its governance as they wish (e.g., the private company could give all members equal management authority, or it could name certain persons as managers, or it could have a formal elected body like a PT's Board of Directors or Commissioners and formal shareholder meetings as in the present company law). However, there should also be a "default" provision that specifies the structure if the members do not agree otherwise (for example, it could state that they have equal authority as in a partnership).	Medium	Medium-Term

33	New Company Law (Private and Smaller)	Allow a private company's members, unlike in a PT, to share votes and share profits and other distributions as they wish (e.g., equally, on a family basis, in proportion to their capital contributions, or on some other agreed-upon basis). Arms-length joint ventures might have several classes of ownership units with different votes, different rights to appoint a particular manager or board member, etc. However, the law should state how such things are shared if the members do not agree otherwise (for example, it could state that they share equally in that case).	Medium	Medium-Term
34	New Company Law (Private and Smaller)	Allow a private company, by agreement of the members, to impose whatever restrictions on sale of shares they wish (e.g., free transferability (no restrictions), transferability only to family members or other company members, requirement of a first offer to the company or to existing members). However, the law should state how transfer is restricted if the members do not agree otherwise (for example, it could restrict transfer to inheritance or transfer with unanimous or "X%" shareholder approval)	Medium	Medium-Term
35	New Company Law (Private and Smaller)	Provide that decisions in a private company are made by majority voting power except that certain very major decisions require unanimous consent, such as admitting a new member, amending the charter, sale of the company's assets, merger with another company, etc. However, the law should also allow the members to vary even those requirements.	Medium	Medium-Term

Contract Law and Enforcement

No.	Type	Recommendation	Priority	Duration
1	Civil Code Reform	In the long term, revise the Civil Code to reflect current and changing business conditions. Particularly, the "general and overriding" provisions should be clarified and more provisions should be added to make it clear to lawyers and investors that the law is open and flexible, and that its overly-specific provisions cannot be used override or frustrate pro-business intentions.	Low	Long-Term
2	Institutional Reform/Anti-Corruption	Increase endeavors to eradicate corruption within the courts. This effort is very important to ensure the court system works properly.	High	Long-Term
3	Institutional Reform	Improve court system and make it more efficient, particularly in the areas of deliberation time and cost	High	Medium-Term

Real Property

No.	Type	Recommendation	Priority	Duration
1	Education and Training	Educate interest groups on potential alternatives for fixing the Indonesian property system.	Medium	Medium-Term
2	Procedural Reform	Increase transparency of records so that information on land ownership is not held exclusively by BPN officials.	High	Short-Term
3	Procedural Reform	Increase public access to the BPN registration systems. It is anti-democratic to require that the public use private intermediaries (i.e., PPATs) to register documents.	High	Short-Term
4	Procedural Reform	Increase the pace of land registration in the informal, customary system. Consider cheaper and more efficient methods of surveying, such as using satellite imagery.	Medium	Medium-Term/ Long-Term
5	Procedural Reform	Encourage competition in pricing vis-à-vis the services of Land Conveyors and notaries.	Low	Short-Term

6	Education and Training	Improve training on enforcing the summary nature of extra-judicial foreclosures. Courts should demand a minimum threshold of documentary evidence to support a claim that an extra-judicial foreclosure sale was improperly conducted. Consider a change in the law to make extra-judicial foreclosures truly extra-judicial; there should be no need for the court to confirm the sale or for a court sheriff to conduct an auction.	High	Medium-Term
7	Legislative Reform	Encourage government officials, legislators, and civil society stakeholders to reach a consensus on proposed legislative reforms.	High	Medium-Term

Secured Transactions

No.	Type	Recommendation	Priority	Duration
1	Legal Reform	While broad legal reform is needed, incremental steps may be taken while broader reform is discussed and developed. Technical requirements of the various secured transactions forms should be analyzed for their commercial practicality. The test of each formal requirement should be whether it promotes commerce. Where legal technicalities fail to promote commerce, legislative proposals should be advocated to eliminate them. Examples of unnecessary formalities include: - The requirement that a fiduciary guarantee agreement be drawn in the form of a notarial deed - The requirement that collateral be described specifically - The requirement that agreements and registration applications contain the value of collateral and the amount of the secured debt - The requirement that obligors on assigned accounts be notified of the assignment.	High	Medium-Term/ Long-Term

2	Policy Reform	A broad discussion about modern secured transactions financing law and policy should be initiated and moderated among private sector stakeholders and interested NGOs. Policy proposals and legislative solutions should be developed and brought to the attention of policy-makers in the executive and parliamentary branches of government. Private sector stakeholders should prepare for an advocacy role in accomplishing legal reform.	High	Long-Term
3	Policy Reform	At least for the purpose of notice and priority, the various forms should be treated in the same manner (e.g., conditional sale, assignment, consignment, fiduciary guarantee). A search of registry records should reveal information about any of these transactions.	High	Medium-Term
4	Policy Reform	Priority rules must anticipate conflict among secured creditors no matter what form of transaction was selected. The priority rules must resolve the potential conflict in a manner that promotes commerce. Conflict among holders of non-consensual property rights should be included in the priority scheme (e.g., judgment holders and tax lien holders).	High	Medium-Term
5	Registry Reform	Comprehensive registry reform is necessary to promote a healthy environment for secured lending.	Medium	Medium-Term/ Long-Term
6	Procedural Reform	Registration should not be a step required merely to transfer collateral rights from one person to another. People should be free to transfer property rights without intervention by or permission from a governmental body.	Medium	Medium-Term/ Long-Term
7	Registry Reform	Registration should not be a step required for enforcement of property rights against a debtor. Registration should be merely a requirement for asserting a claim against third parties where appropriate under properly drawn priority rules.	Medium	Medium-Term/ Long-Term
8	Registry Reform	Registry records must be truly open to the public so that buyers of property and prospective secured creditors may determine whether a prior legal claim to property may exist.	Medium	Medium-Term
9	Registry Reform	The public nature of registry records must be supported by modern technology by which records are indexed in a database for convenient search by any member of the public. Regional and international models for internet-based searching should be examined and implemented.	Medium	Medium-Term
10	Registry Reform	The registry must simplify registration procedure and abandon paternalistic controls over information submitted for registration. Regional and international models for internet-based registration should be examined and implemented.	Medium	Medium-Term
11	Policy Reform	Enforcement of secured creditor rights must be strengthened.	High	Short-Term

12	Judicial System Reform	For tangible property, the creditor's right to possession upon default must be given meaningful effect through streamlined judicial process.	Medium	Short-Term/ Medium-Term
13	System Reform	Non-judicial enforcement techniques should be authorized and tailored to the appropriate type of collateral. For example, upon default and without judicial intervention, the law should authorize the creditor to negotiate an instrument, collect on receivables, and take control and dispose of goods subject to a warehouse receipt or bill of lading. Delay tactics by the debtor must not be tolerated, though the debtor should be entitled to compensation for any abuse of authority by a creditor.	Medium	Medium-Term/ Long-Term

Bankruptcy Law

No.	Type	Recommendation	Priority	Duration
1	Procedural Reform	Improve the recordkeeping system, including post-bankruptcy events. The most fundamental, tangible, and non-controversial improvement would be reform of the bankruptcy recordkeeping system. The end result would be a system where documents submitted to the supervisory judge are collected and logged in a typical case file/docket sheet recordkeeping system. With the introduction of minimal new technology, this could allow creditors to scan and monitor case files via the internet.	Medium	Long-Term
2	Procedural Reform	Develop a benchbook that standardizes and simplifies decision-making. A bankruptcy benchbook would promote recordkeeping where currently there is little or none, and facilitate quicker and better decision-making. The benchbook would contain an inventory of every possible decision a judge might face during a bankruptcy proceeding. For each possible decision, the benchbook should contain an analytical framework for making the decision and a form to help the judge create a paper record.	Medium	Long-Term

3	Further Analysis	Engage an NGO to conduct a study on Pauline actions, inter-agency cooperation, and the use of auctions in bankruptcy. A Pauline action is the method by which the court may order the reversal of a past transaction of a bankruptcy debtor that is harmful to creditors. Inter-agency cooperation is necessary to locate assets and encourage the debtor to cooperate. Auctions are the means by which a curator assures himself, the court, and the creditors that sales of assets of a bankruptcy debtor approximate their market value.	High	Medium-Term
4	Further Analysis	Build a dialogue between the commercial court and creditors; encourage creditors to use bankruptcy law. Court and curator performance will improve if creditors are better able to shoulder more of the burden. Creditors can do better to monitor and police the system. Under ideal conditions, the creditors have access to records, take part in decisions, and can complain when things go wrong. Under current conditions, few creditors put in the effort.	High	Medium-Term
5	Education and Training/Further Analysis	Courts must recognize the role that creditors play and enter into a policy dialogue on how creditors can be better protected through the process. This could be done by sponsoring a series of workshops or dialogue sessions between judges and creditors. A manual on how creditors can protect their rights in bankruptcy would also be helpful.	High	Medium-Term/ Long-Term

Competition Law and Policy

No.	Type	Recommendation	Priority	Duration
1	Education and Training	Take a leadership role in educating stakeholders about the principal objectives of competition law and policy in Indonesia through the issuance of guidelines, publications, speeches, and written decisions.	High	Short-Term
2	Legislative Reform	Address the inherent ambiguities in the substantive provisions of the Law No. 5, and respond to stakeholders' future needs in a timely manner. In this regard, the KPPU should consider establishing a more formal mechanism for the receipt of regular input from and providing feedback to stakeholders.	Medium	Medium-Term

3	Case Reform	Modifying its case-handling procedures to provide a higher degree of due process safeguards by providing the target of the investigation sufficient notice and opportunity to develop a complete evidentiary record.	Medium	Medium-Term
4	Education and Training/Institutional Reform	Develop the capacity to conduct economic-based investigations and analysis, which should be openly reflected in its internal procedures and written case decisions. The KPPU should consider establishing an Economics Directorate consisting of a PhD. economist, specifically trained in industrial economics and antitrust analysis, and a staff of economists whose primary responsibility is to provide economics-based analysis. Additionally, the KPPU might wish to consider having its staff specialize by area of law or industry.	Medium	Long-Term
5	Case Reform	Exercise prosecutorial discretion in its case selection.	Medium	Short-Term

Commercial Dispute Resolution

No.	Type	Recommendation	Priority	Duration
1	Court Reform	The courts should consider following Bandung's lead in utilizing court-annexed mediation.	Low	Medium-Term
2	Education and Training	Support for training in arbitration and mediation skills could be greatly increased.	High	Short-Term
3	Education and Training	An effort to ensure that foreign arbitration awards are strictly enforced should take place through training and better information provided to law students, lawyers, and judges.	High	Short-Term
4	Court Reform	A mechanism for dismissing frivolous cases should be established at all levels.	Medium	Medium-Term
5	Education and Training	Judicial training should be increased, with an emphasis on updating judges' understanding of new laws and improved case management.	Medium	Medium-Term

Court Administration

No.	Type	Recommendation	Priority	Duration
1	Court Reform	Develop and integrate the practice of court reporting by maintaining transcripts from court proceedings. Court reporting represents a first step toward transparency. The Attorney General and the Corruption Eradication Commission (KPK) could videotape all court proceedings in the Anticorruption Court and make copies available to all parties and the court itself. It is the beginning of true transparency.	High	Short-Term
2	Court Reform	Publish judicial opinions on court and/or private websites.	Medium	Long-Term
3	Education and Training	Use the newly revived judicial commission to select and train judges to improve competence on the bench.	High	Short-Term
4	Anti-Corruption	Make a series of small, low-cost efforts to diminish petty corruption. For example, post signs in the clerk's office that say that failure to give a receipt for any court fee is a criminal offense and should be immediately reported to the police.	High	Short-Term

Foreign Direct Investment

No.	Type	Recommendation	Priority	Duration
1	Court Reform	Commercial court judges should have to publish their decisions on the Internet within three days of the completion of a case.	High	Long-Term
2	Court Reform/Anti-Corruption	The court should follow the lead of the newly-established Anti-Corruption Court by assigning ad hoc judges from among academics and other civil society actors who have good character, integrity, and expertise.	High	Short-Term
3	Education and Training	Print and broadcast journalists should be trained in coverage of economic and business issues. Exchange programs with western journalists should supplement this training.	Medium	Medium-Term

4	Licensing	Best practices in licensing and permitting should be disseminated to the provinces, districts, and municipalities so that these recently decentralized functions can be made less unpredictable throughout the country.	High	Medium-Term/ Long-Term
5	Institutional Reform	Bureaucracy must be reformed. It is urgent to apply good governance principles and change the culture of government officers from officials holding power to civil servants providing services.	High	Long-Term
6	Institutional Reform/Anti-Corruption	The endeavors to eradicate corruption must be continued. This effort is very important to reduce the high cost of investment.	High	Long-Term
7	Legislative Reform	The labor law should be revised to reduce required severance pay to levels consistent with the rest of the ASEAN region. To secure cooperation in this reform of organized labor, a modest but predictable payroll tax could be instituted to fund unemployment insurance and pensions.	Medium	Medium-Term
8	Institutional Reform	Indonesia should reinvigorate its program to privatize state-owned enterprises, many of which serve as sources of funding for political campaigns and costly drains on public finance, and most of which crowd out more competitive private investments.	Medium	Long-Term
9	Institutional Reform	BKPM should further reduce the scope of the negative list, which prohibits private investment in certain sectors and restricts foreign participation in others. The consumers of all goods and services would benefit from increased competition.	Medium	Medium-Term

International Trade Law and Policy

No.	Type	Recommendation	Priority	Duration
1	Civil Service Reform	The development and effective execution of trade policy and the effective facilitation of trade transactions depend on comprehensive civil service reform. With donor assistance, civil service reform could be developed prior to the 2008 elections and implemented soon thereafter.	High	Medium-Term
2	Court Reform	Just and timely settlement of commercial disputes requires the continued development of independent commercial courts.	Medium	Long-Term

3	Customs Reform/Anti-Corruption	Graft and inefficiency in the Customs department substantially increase the costs of imports. The increased use of e-commerce will make Customs transactions faster and more transparent and decrease the face-to-face contact that provides opportunities for corruption.	Medium	Short-Term/ Medium-Term
4	Donor Assistance Coordination	Increasing popular support for trade liberalization would help enable reform. Donors could support training for Indonesian journalists in coverage of economic issues and establish exchanges with foreign economic reporters.	Medium	Long-Term

Flow of Goods and Services

No.	Type	Recommendation	Priority	Duration
1	Customs Reform	Expand the Priority Line program that allows compliant large importers to speed their goods through Customs processes. This approach should continue while the major reforms and programs proceed. Numerous countries have adopted this approach to allow their limited resources to focus on high-risk shipments while providing tangible benefits to legitimate businesses. Treating these companies as accounts, appointing Customs-employed account managers, and instituting a special set of compliance, risk criteria, and post-release audit for select companies could allow many legitimate companies true expedited service and separate their shipments from the flow of riskier imports.	High	Long-Term
2	Customs Reform	Consider adding a problem resolution capacity to the planned special Customs office for priority client coordination. Client Coordinators could act as the focal points to resolve Customs issues clients encounter at the ports. This function has been a very popular and effective aspect of Egypt's Gold Card program, and could prove similarly effective in Indonesia.	High	Medium-Term
3	Customs Reform	Support efforts by the Association of Priority Lane Companies (APJT) to streamline operations at the port of Tanjunk Priok. These include assisting APJT in analysis of current environment, making available to them regional best practices, and garnering the support of other trade associations to promote adoption of recommendations.	Medium	Medium-Term/ Long-Term

4	Customs Reform	Procure a modern, automated Customs transaction system such as ASYCUDA World, and ensure that the modules that provide manifest accountability, selectivity, and improved collections are faithfully implemented along with changes in the underlying business processes. Additionally, Direct Trader Input (DTI) should be mandated, or at least encouraged. Disincentives such as charging a processing fee for DTI should be discontinued. A true expedited service should be offered as an incentive for DTI. A new system would also allow for better risk management.	High	Medium-Term/ Long-Term
5	Customs Reform	Consider acceding to the WTO's Revised Kyoto Convention (RKC). A gap analysis between the DGCE Customs Law and business procedures with those of the RKC should be undertaken. This convention reflects the current economic and technological changes necessary for a modern Customs administration that conforms to international standards and practices. The RKC also incorporates best practices of member administrations. The RKC is an excellent means for facilitating trade, ensuring economic growth, and improving the security of the international trade system. Such an effort is now underway by the Bureau of Customs in the Philippines. Reform efforts of the DGCE would be greatly enhanced by such an effort.	Medium	Medium-term
6	Customs Reform	Use Post-Release Audit to identify importers that are compliant and knowledgeable about Customs and Other Control Authority laws and regulations, and then put their shipments into a an expedited service.	Medium	Short-Term
7	Customs Reform	Reduce human contact and the need for Customs intervention between the Customs officer and the Customs broker by excluding the private sector from the DGCE official entry processing units. Brokers should have a designated box for submission of their documents that should be time- and date-stamped. They should retain a copy of the stamped entry as evidence of submission. Final documents needed by the trade should be placed in a single area for pick up.	Medium	Long-Term
8	Customs Reform	Review new Customs legislation and the yet-unpublished executive regulations to measure the consequences of the reform on the honest trader. There are reasonable alternatives to tightening controls on an operation while maintaining a balance on facilitation. Draconian penalties do not ensure a compliant trading community.	High	Short-Term

9	Customs Reform/Anti-Corruption	Enhance anti-smuggling efforts and develop a comprehensive strategy with trade, its associations, public officials, and international experts. Other countries have successfully addressed these issues through such coordinated efforts.	High	Medium-Term
10	Education and Training	Provide human resource training in modern business practices for port and transport companies. These would include promulgation of a modern service mentality and management and adoption of integrated IT services.	Medium	Medium-Term
11	Modernization of Processes	Prepare a new strategic plan for DGCE that includes an implementation plan incorporated into the overall document. A special group or reform unit should be created to implement and monitor the plan.	High	Long-Term
12	Procedural Reform	Place special emphasis on integrating the border operations of the DGCE with the other control authorities, especially health and agriculture. The SAD and procedures from the upcoming National Single Window test should be expanded to all of Indonesia. Other control authorities should have access to the DGCE automated system, the ability to place and remove holds, and the ability to use certain functions, such as the selectivity and collections functions.	Medium	Long-Term
13	Modernization of Processes	Review and update the current DGCE website. Transparency and better public service would be enhanced by the addition of: -Pertinent laws, regulations, and directives, either existing or approved -Procedures for joining programs such as Priority Lane -Contact information for problem resolutions -Customs tariff and classification guides -Links to other Indonesian Control Authority websites -Links to International Customs websites -DGCE rulings -Audit procedures -Schedules of legitimate fees -Broker's notices -Other pertinent news, data or information.	Medium	Medium-Term

14	Donor Assistance Coordination/Anti-Corruption	Provide assistance to the DGCE to support its ongoing efforts to improve the efficiency of the agency and reduce corruption. Donor assistance (particularly in the area of Customs automation and integration of other border agency activities), which is currently not flowing to the agency, should be undertaken with a well defined scope of work and anticipated results required for continued funding. Today's assistance, generally in the form of anti-terrorism efforts, could be used to establish the necessary foundation. These efforts would lend international support and continued pressure for modernization and reform of the agency.	High	Long-Term
15	Customs Reform	Adopt a one-stop port service office. Streamline the process as much a possible and then establish an office where representatives of all the remaining functions can be co-located to complete all required documentation. Elimination of ad hoc obstacles should be a priority. Visits to other, more efficient ASEAN port locations would be beneficial when developing this project.	Medium	Long-Term
16	Customs Reform	Offer incentives to reward public officers who effectively implement and support meaningful reform measures. Review of the program regarding Customs and Priority Lane customers could be a stating point.	Low	Medium-Term
17	Customs Reform	Expedite the development of the port of Bojonegara as an alternative to Tanjunk Priok. The contract requirements for privatization must clearly demand the delivery of modern port efficiency standards and an integrated IT management system. Allow the operator to employee a professional work force.	Medium	Medium-Term
18	Procedural Reform	Improve security of movements out of economic zones to the ports by implementing a tracking system that includes arrival and departure actions to close a file, condition of seals on containers, and travel time limits. This would be a major step in reducing the amount of bonded goods that enter the Indonesian black market.	High	Long-Term
19	Procedural Reform	Designate a clear authority within the ports for overall security and define the role of all participants. This authority must be vested with authority over the other involved agencies to ensure compliance with requirements and adequate leadership.	High	Medium-Term

Flow of Money

No.	Type	Recommendation	Priority	Duration
1	Institutional Reform	Deepen the offerings of financial sector participants engaged in providing trade finance. Increasing the types and availability of trade-related products as well as the quality of existing products would enable currently marginalized small and medium-size businesses to more efficiently and competitively engage in currently existing trade opportunities.	High	Medium-Term
2	Legislative Reform	Pass legislation allowing the transformation of BEI, Indonesia's export credit agency, into an official Exim Bank of Indonesia. This agency would provide Indonesia's smaller exporters and importers with a level of support not available under the current system, allowing them to compete more effectively in the global market.	Medium	Short-Term
3	Procedural Reform	Encourage investors to migrate into long-term credits. Increasing the volume of long-term credits in Indonesia would help stabilize the Indonesian economy and build investor confidence in the Indonesian banking sector. Because investor confidence is also required to stimulate movement toward long-term credits, both the government and the banking sector as a whole must actively promote long-term credits through continued development of the capital markets.	Medium	Long-Term
4	Procedural Reform	Encourage improved public and private sector coordination around trade finance issues. There are incentives on both sides to advance the relatively anemic growth of the trade finance regime. The government and the private sector should more consistently communicate about the range of barriers that hinder the development of trade finance.	High	Medium-Term

Flow of People

No.	Type	Recommendation	Priority	Duration
1	Procedural Reform	Lessen the amount of paperwork and remove seemingly repetitive steps in the visa issuance process, such as having to register with the police twice.	Medium	Short-Term
2	Procedural Reform	Create a one-stop window for the visa issuance process so that applicants are not required to make multiple trips to a variety of agencies, including the police, the immigration office, and the labor directorate.	Medium	Short-Term
3	Procedural Reform	Develop online services for immigration, such as making more easily available all forms needed for visa issuance and allowing for the completion and submission of such forms online.	Medium	Short-Term
4	Institutional Reform	Improve services for migrant workers, including: better recruitment, education and training prior to departure; better protections, including consular and legal services, while abroad; and greater support of migrant workers upon their return. Models of such efforts exist in the region, such as in the Philippines.	Medium	Short-Term/ Medium-Term
5	Institutional Reform	Improve the government's capacity to employ appropriate strategies and technology to monitor and take action against irregular migration, and address other critical issues such as human trafficking and smuggling.	Medium	Medium-Term

Financial Crimes

No.	Type	Recommendation	Priority	Duration
1	Legislative Reform	Draft and pass critical amendments to existing legislation that bolster the regime, including an asset forfeiture law and its implementing regulations, and a criminal procedure code for improving coordination between law enforcement and the court system.	High	Medium-Term
2	Institutional Reform	Provide supervising and investigating entities with sufficiently sophisticated equipment, such as state-of-the art computers, to meet the demands of the technical nature of investigating financial crimes and improving interagency communications.	High	Medium-Term

3	Education and Training	Tailor a regularly occurring training course to law enforcement officials, particularly police, on best practices for financial crimes-related investigation procedures as well as specific case-building techniques (e.g., evidence gathering, interviewing, research).	Medium	Short-Term
4	Education and Training	Provide students with a specialized financial crimes curriculum to ensure that knowledgeable human resources are available in the field.	Medium	Medium-Term
5	Institutional Reform	Attract more professionals from specialized professions, such as accountants and auditors, into the field.	High	Medium-Term
6	Procedural Reform	Improve interagency coordination to strengthen the implementation of existing legislation, limit stalling of progress toward constructing a sound AML regime, and reduce political infighting.	High	Short-Term/ Medium-Term
7	Education and Training	Train professionals engaged in financial crimes investigation and prosecution (e.g., FIU, police, courts) remains valuable, though there should be a focus on building this capacity within Indonesia.	High	Medium-Term

Intellectual Property

No.	Type	Recommendation	Priority	Duration
1	Legislative Reform	With respect to current legislation and regulation, missing regulations such as dealing with license agreements, Customs' role with respect to IP, and injunctive relief related to possible IP violations should be promulgated.	High	Medium-Term
2	Legislative Reform	As the law has been expanded to include liability for owners of shopping malls who allow their tenants to sell pirated and counterfeit goods, the possibility of creating criminal liability for those who knowingly purchase counterfeit goods should also be explored.	Medium	Medium-Term
3	Further Analysis	Data is needed with respect to levels of counterfeit exports to help the police and Customs better target enforcement efforts.	Medium	Short-Term
4	Procedural Reform	The DG IPR registration process should be improved by employing information technology solutions. This will make the registration process more efficient, consistent, and transparent.	High	Short-Term

5	Institutional Reform	The DG IPR should be made an independent agency, giving it full control over its budget and hiring and firing practices. In addition, all fees paid to the DG IPR should remain in its control.	High	Medium-Term/ Long-Term
6	Wage Reform	With respect to the police, salaries should be raised so that police officers are less susceptible to bribes. In addition, the police should be better funded to allow for more and deeper investigations into possible IP protections violations.	High	Short-Term
7	Education and Training	Training should be expanded for judges, court staff, attorneys, and IP consultants with respect to IP issues.	High	Short-Term
8	Education and Training	Renewed efforts should be undertaken to modify societal attitudes through education about the importance of IP protections. A public-private partnership should be developed to assist in the development of a public education strategy. This could have the additional beneficial effect of reinvigorating domestic civil society's interest in IP.	High	Medium-Term
9	Education and Training	Support should be given to academic institutions so that they can expand their IP education efforts.	High	Medium-Term
10	Procedural Reform	Rights holders should be encouraged to be more involved in the process. This includes being more knowledgeable of their rights, being more active in investigation of cases, and supporting and participating in civil society organizations.	Medium	Medium-Term
11	Procedural Reform	While recent police raids against counterfeiting operations is an excellent start, these will be merely symbolic gestures if those arrested are not prosecuted, a step that has been lacking in prior such circumstances. Generally speaking, efforts must be made to ensure stronger prosecutions.	Medium	Medium-Term

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